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In The

Supreme Court of the United States

ALVIN W. GEBHART, JR. and DONNA T. GEBHART,

Petitioners,

v.

SECURITIES AND EXCHANGE COMMISSION,

Respondent.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Does reckless conduct satisfy the essential element of scienter for violations of section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5, promulgated thereunder, even where there is uncontroverted evidence of subjective good faith?

PARTIES TO THE PROCEEDING

The caption contains the names of all the parties to the proceeding below.

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PETITION FOR A WRIT OF CERTIORARI

Petitioners Alvin W. Gebhart, Jr. and Donna T. Gebhart respectfully request that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Ninth Circuit in this case.

OPINIONS BELOW

The opinion of the Court of Appeals below (App., *infra*, 1a-21a) is reported at 595 F.3d 1034 ("*Gebhart II*"). The Securities and Exchange Commission's ("Commission's" or "SEC's") order that was the subject of the 2010 appeal (App., *infra*, 22a-61a) was published as SEC Release No. 58951. A previous order by Court of Appeals (App., *infra*, 62a-66a) is unreported but may be found at 255 Fed. Appx. 254 ("*Gebhart I*"). The Commission's first order was published as SEC Release No. 53136 (App., *infra*, 67a-129a). The National Association of Securities Dealers ("NASD") National Adjudicatory Council's ("NAC's") decision is unpublished (App., *infra*, 130a-180a). The NASD Hearing Panel decision is also unpublished (App., *infra*, 181a-223a).

JURISDICTION

The opinion of the United States Court of Appeals for the Ninth Circuit was entered on February

17, 2010. The jurisdiction of this Court is invoked under 28 U.S.C. §1254(1).

STATUTE AND RULE INVOLVED

Section 10 of the Securities Exchange Act of 1934, 15 U.S.C. §78j (2000) ("Manipulative and deceptive devices") provides, in pertinent part:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange –
>
> * * *
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement . . . , any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

SEC Rule 10b-5, 17 C.F.R. §240.10b-5 (2010) ("Employment of manipulative and deceptive devices"), provides in pertinent part:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or

> instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> * * *
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading. . . .

STATEMENT OF THE CASE

Petitioners Alvin W. Gebhart, Jr. ("Mr. Gebhart") and Donna T. Gebhart ("Mrs. Gebhart"), husband and wife, are licensed financial planners and securities dealers. Based on their own experience with certain investments, they recommended those investments to their existing clients. When those investments collapsed, they worked tirelessly to recover a substantial amount of their clients' money. Regulators subsequently charged them with securities fraud for making materially false and misleading statements to their clients, premised solely on Petitioners' failure to conduct a reasonable investigation into those investments before recommending them.

This case presents an important, recurring, and open question concerning scienter, an essential element of violations of the antifraud provisions of section 10 of the Securities Exchange Act of 1934

("1934 Act"), 15 U.S.C. §78j, and SEC Rule 10b-5, 17 C.F.R. §240.10b-5 (2010), promulgated thereunder. This Court has defined scienter as "a mental state embracing intent to deceive, manipulate, or defraud." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12, 199 (1976). The scienter element effectuates Congressional intent "to proscribe knowing or intentional misconduct" only, and permits liability to attach only to those practices "acted other than in good faith." *Id.* at 197, 206. Indeed, as this Court recognized last term, the essential element of scienter is satisfied only with proof "that a defendant made a material misstatement *with an intent to deceive* – not merely innocently or negligently." *Merck & Co. v. Reynolds*, No. 08-905, 559 U.S. ___, slip op. at 13 (2010) (citing *Hochfelder, supra*; *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 319 (2007)).

Congress enacted the Securities Act of 1933 and the Securities Exchange Act of 1934 in the aftermath of the market crash in 1929. Among other things, the 1934 Act intends principally to protect investors against manipulation of stock prices through regulation of professionals and transactions in the securities exchanges and over-the-counter capital markets. *See Hochfelder*, 425 U.S. at 194-95. To complement the Act's express private remedies, Congress created the Commission, which it provided with considerable enforcement powers. A significant source of those powers is §10(b), which makes it unlawful for any person "[t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative

or deceptive device or contrivance in contravention" of the Commission's rules. The Commission promulgated Rule 10b-5 in 1942, pursuant to its §10(b) authority. *See id.*

The case at hand involves a core §10(b) and Rule 10b-5 matter: the regulation of securities professionals. It originated as a disciplinary action by NASD against Petitioners for, among other acts not at issue here, violations of §10(b) and Rule 10b-5. Specifically, NASD charged Petitioners with recklessly making material misrepresentations and omissions because they failed to reasonably investigate securities sold to their clients. Petitioners conceded their conduct was negligent, but in good faith.

Although the initial hearing panel found Petitioners did not violate §10(b) and Rule 10b-5, a NASD review board reversed. The Commission reviewed the NASD orders pursuant to 15 U.S.C. §78s(d)(2), and affirmed. The Ninth Circuit reviewed the Commission's order pursuant to 15 U.S.C. §78y(a)(1), affirming in part, but reversing and remanding the scienter findings. On remand, the Commission again found scienter and the Ninth Circuit subsequently affirmed.

Hochfelder holds that a violation of §10(b) must be premised on an "intent to deceive, manipulate, or defraud." 425 U.S. at 193 n.12, 199. Negligence is insufficient for §10(b) liability, because Congress "intended to proscribe knowing or intentional misconduct," *i.e.*, acts made "other than in good faith." *Id.* at 197, 206.

Because it was concerned with negligence allegations, *Hochfelder* left open the question posed by this case: whether recklessness suffices as scienter. 425 U.S. at 193 n.12. Eleven of twelve Circuits hold that reckless conduct constitutes scienter, but in doing so, the Circuits ignore *Hochfelder* and its progeny. Briefly summarized, *Hochfelder's* focus is on statutory construction, looking specifically to: (1) "the plain meaning of the language of §10(b)"; (2) "the legislative history of §10(b)"; and (3) "the structure of the civil liability provisions in the 1933 and 1934 Acts." *See id.* at 197-99, 201-02, 206-11; *Aaron v. SEC*, 446 U.S. 680, 690 (1980). However, the lower courts' recklessness decisions stray far afield from *Hochfelder* and its progeny. Rather than construing §10(b)'s text, history, and sister provisions, the Circuits articulated their recklessness tests by looking to the common law of fraud and deceit, administrative law principles, and public policy considerations.

By rejecting *Hochfelder's* explicit holding and reasoning, the Circuits created an additional problem: their standards hopelessly conflict. Although they purport to adopt one court's recklessness definition, closer inspection reveals that the Circuits apply at least five different standards. These standards fall along a spectrum ranging from intentional to grossly negligent conduct. They vary not only in degree, *Tellabs*, 551 U.S. at 319 n.3, but also in kind. The result of the Circuits' diverse approaches is conflict: on the very same facts, a defendant may be found liable under some of these recklessness

standards, while under others, found faultless. Indeed, the Circuits apply different recklessness standards to different categories of defendants. For example, broker-dealers and underwriters, two types of securities professionals, may be subject to different recklessness standards in the same Circuit, solely because of their job function.

Section 10(b) and Rule 10b-5 are "among the most, if not the most, litigated provision[s] in all of federal law." S. COHN, 2 SEC. COUNSELING FOR SMALL & EMERGING COMPANIES §19:8 (2009) (hereinafter "COHN"). Yet "years of erratic interpretation by the courts have made [§10(b) and Rule 10b-5] unworkable tool[s] with which to achieve any legitimate objective of federal securities law." *See* 1 BROMBERG & LOWENFELS ON SECURITIES FRAUD §2:29 (2d ed. 2009) (hereinafter "SECURITIES FRAUD"). "Pronouncements on scienter are particularly prone to word manipulation for the justification of results reached on other, often unexpressed grounds." 4 SECURITIES FRAUD §7:127.

The case at hand exemplifies these problems. As residents of California, Petitioners were presumably subject to the Ninth Circuit's reckless scienter standard. On the same facts, regulators and courts alternatively exonerated Petitioners or held them liable. Adjudicators at every level of proceedings applied different, and sometimes contradictory, recklessness standards from the Second, Third, Fifth, Seventh, and Ninth Circuits, as well as common law fraud and deceit. The Ninth Circuit itself announced an entirely

novel rule. Yet these different outcomes were not solely the result of a reviewing court's error correction function or a fortuitous change in the law. Instead Petitioners faced a constantly shifting legal landscape, which is the product of the Circuits' conflicting tests and constructions of a key federal statute in the regulation of the nation's capital markets.

A final, definitive exposition of this essential element of §10(b) and Rule 10b-5 claims by this Court is therefore necessary.

A. The Nature Of The Case.

Mr. Gebhart had been a licensed insurance salesman for twenty years. He obtained his first securities licenses (Series 6 and 63) in the early 1990's while working as a representative for MONY Securities Corporation ("MONY") (App., *infra*, 3a, 184a).

Mrs. Gebhart, a former court reporter, obtained her securities licenses and began working with her husband in 1996 (*id.*). Before 2000, neither experienced any disciplinary action, customer complaints, or compliance problems. Even after disclosure of the events underlying these proceedings, Petitioners enjoy their clients' continued trust; their clients consider Petitioners to be fraud victims, too (App., *infra*, 19a-20a, 219a-220a).

Mr. Gebhart met John T. Archer ("Archer") while they both worked in the same office at MONY. Archer solicited Mr. Gebhart for clients that might be

interested in investment opportunities with an entity named Community Service Group ("CSG"). CSG financed the conversion of mobile home parks to tenant ownership, a process similar to condominium conversions of apartment buildings. CSG would raise capital to purchase, or assist residents in purchasing, the parks from their owners. Mr. Gebhart arranged for three of his clients to meet with Archer, and based on Archer's presentation, they invested with CSG. Archer earned a sales commission, and paid half of the commission to Mr. Gebhart (App., *infra*, 27a-28a, 187a-189a).

In October 1996, and after Petitioners began working for Mutual Service Corporation ("MSC"), Archer visited them in San Diego. He suggested promissory notes ("Notes") issued by California-based MHP Conversions, LLC ("MHP") as possible investments for their clients. MHP was formed in 1996 to provide CSG with bridge financing for its mobile home park conversions through the Notes. The Notes purported to be secured by second trust deeds on the particular park to be purchased, but until such trust deeds were recorded, they were to be secured against a $100,000 trust deed owed by MHP in a park in El Cajon, California (App., *infra*, 3a-4a, 70a-72a).

Archer offered to pay Petitioners a finder's fee if they would introduce some of their clients to the Notes. He represented that MONY's compliance department had approved the Notes. He urged Petitioners to obtain approval from the MSC Compliance Department before selling the Notes. Petitioners

submitted the investment to MSC for review, and appeared to secure approval from its compliance department.[1] From 1996 to 2000, Petitioners regularly supplied MSC's auditors and compliance personnel with records of their transactions and copies of the Notes, without objection (App., *infra*, 190a-193a).

Before recommending the Notes to their clients, Mr. Gebhart made physical visits to two of the parks. His visits corroborated Archer's statements. Mrs. Gebhart purchased Notes with money from her retirement account. When the note came due, she was paid without delay. Petitioners thereafter made personal investments of dollars in the Notes, totaling nearly $70,000 (App., *infra*, 5a, 19a-20a, 29a, 80a).

Between the October 1996 meeting with Archer and 2000, Petitioners sold nearly $2.4 million in MHP promissory notes to 45 of their clients, earning about $105,000 in commissions. The sales were based in part on several statements made by Petitioners that, in hindsight, proved false. They repeated to their clients Archer's representations to them: the Notes

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[1] Mr. Gebhart relayed the investment opportunity to MSC's Chief Compliance Officer over the phone. That officer indicated his approval over the telephone. Mr. Gebhart thereafter sent him documents and materials and received no response. The officer subsequently explained that he did not act because he thought the investment was a "joke" (App., *infra*, 79a). In an unrelated proceeding, this person was disciplined for failure to supervise MSC's compliance department. *Dept. of Enforcement v. Mutual Service Corporation*, 2008 FINRA Discip. LEXIS 62, *87-90 (2008).

were a proven investment that offered substantial returns, which were secured by recorded deeds of trust. Although these statements had some basis in fact in 1996, they were no longer true by 2000 (App., *infra*, 7a, 71a-72a).

CSG and MHP collapsed in 2000. In May, a CSG officer sent a letter to MHP noteholders, in which he disclosed that few of the deeds of trust purportedly securing the notes were recorded. In fact, MHP had nearly $3,670,000 in outstanding promissory notes, of which only $605,000 were secured by recorded trust deeds. What is more, all of the parks that served as security for the Notes were substantially overencumbered. At the time of MHP's collapse, Petitioners' clients had over $1.5 million invested in outstanding Notes. (App., *infra*, 7a-8a, 71a-72a, 90a-91a).

After discovery of the fraud, Petitioners sought assistance from MSC to protect their customers' interests. MSC refused, and terminated Petitioners. Petitioners then initiated involuntary bankruptcy proceedings against CSG and its related entities. Petitioners and MSC were subsequently named as defendants in a class action suit by their clients. Petitioners cooperated with their clients, even filing suit against their insurer for contribution. As a result, Petitioners' clients recovered 84% of their losses (App., *infra*, 39a, 90a-91a, 200a).

B. The Administrative Proceedings.

On December 31, 2002, NASD initiated disciplinary proceedings against Petitioners and Archer[2] concerning the Notes. Among other things, NASD alleged that Petitioners recklessly made false and misleading statements in violation of §10(b) and Rule 10b-5. The violations were premised on a failure-to-investigate theory: as broker-dealers, Petitioners had a duty to conduct a reasonable investigation into a security before recommending it to their clients. By recommending the Notes, Petitioners impliedly warranted that they had an adequate basis for their recommendation, based on a reasonable investigation. According to NASD, Petitioners' implied warranties were reckless and false because their underlying investigation was unreasonable (App., *infra*, 182a-183a, 206a-207a).

The NASD hearing panel disagreed. It found Petitioners "truly believed" they had discharged their investigation duties based on Archer's statements, which appeared reliable at the time, Petitioners' own investigation and research, their own experience with MHP's payment history, and MSC's tacit approval of the Notes. The hearing panel found Petitioners credible, remorseful, and sincere, and that their recommendations were intended to meet their clients' goals, as opposed to earning larger commissions for

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[2] Archer defaulted in the proceedings below (App., *infra*, 182a-183a).

themselves. Applying precedent from the Fifth Circuit, the hearing panel found no scienter, because Petitioners' conduct was "negligent, perhaps even grossly negligent," but not intentional or reckless[3] (App., *infra*, 207a-208a, 219a-220a).

NAC, a NASD review board, *sua sponte* reviewed the hearing panel's decision. Pursuant to authority from the Second and Seventh Circuits, it found that Petitioners' failure to investigate the Notes was reckless, and thus, violated §10(b) and Rule 10b-5. It second-guessed Petitioners' efforts at due diligence, despite the record's lack of expert testimony as to the standard of care for a reasonable investigation under the circumstances. Based on Third Circuit authority, NAC rejected Petitioners' good faith evidence as well as the panel's credibility decisions, because Petitioners' good faith beliefs were objectively unreasonable (App., *infra*, 164a-171a).

The Commission affirmed NAC's decision. Based on authority from the Second Circuit, the Commission concluded Petitioners recklessly engaged in fraudulent and deceptive acts and practices contrary to §10(b) and Rule 10b-5(b). It dismissed Petitioners' evidence and argument concerning their subjective

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[3] NASD also alleged violations of NASD Rule 2110 and 2120. NASD Rule 2120 is an antifraud provision that mirrors Rule 10b-5. NASD Rule 2110 requires that members "observe high standards of commercial honor and just and equitable principles of trade." Petitioners' negligent conduct was found to violate NASD Rule 2110 (App., *infra*, 209a).

good faith, because the information Petitioners received was inadequate to provide a reasonable basis for recommending the notes. It did not address whether Petitioners knew or must have known of the falsity of their representations (App., *infra*, 115a-122a).

C. Judicial Review Of The Proceedings.

In *Gebhart I*, the Ninth Circuit reversed and remanded the Commission's scienter findings. The Commission's order was deficient because it did not apply *Sundstrand Corp v. Sun Chemical Corp.*, 553 F.2d 1033 (7th Cir. 1977), which the Ninth Circuit construes to set forth a rebuttable inference approach to scienter. A rebuttable inference of scienter is established by objectively reckless conduct, which may be rebutted by evidence of a defendant's actual state of mind. By failing to consider Petitioners' subjective intent, the Commission's order resembled a negligence finding. It was also troubled by the Commission's conclusion that an unreasonable investigation necessarily forecloses a good-faith defense in failure-to-investigate cases (App., *infra*, 63a-66a).

Gebhart I introduced novel administrative law concepts into the scienter analysis in its remand instructions. On remand, "the [Commission] is entitled to infer from circumstantial evidence that a defendant must have been cognizant of an extreme and obvious risk and reject as implausible testimony to the contrary." (App., *infra*, 64a). In other words, after

an inference of scienter arises from unreasonable conduct, the Commission may reject subjective good faith evidence offered in rebuttal if it thinks such evidence implausible.[4]

Purporting to apply the Ninth Circuit's case law, supplemented by precedent from the Third and Seventh Circuits and common law principles, the Commission again found scienter. It found that Petitioners relied on representations made by Archer and MHP, site visits to two parks, the absence customer complaints, and MSC's acquiescence to the Note sales. Petitioners ignored "red flag" warning signs, such as CSG's and MHP's short history and small size, Archer's role as an intermediary with MHP, Petitioners' lack of access to MHP's books and records after their request to examine them, and the Notes' vague language. Given these red flags, Petitioners' investigation was not "meaningful" because they did not have any of MHP's financial information, made no efforts to ensure the deeds of trust were recorded or that the parks contained sufficient collateral to support the Notes,[5] made no investigation

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[4] *Gebhart I* relied on *Vernazza v. SEC*, 327 F.3d 851 (9th Cir. 2003) as support for these instructions. *Vernazza* in turn purports to apply deference under *Skidmore v. Swift & Co.*, 323 U.S. 134, 140 (1944), to the Commission's findings of fact regarding securities professionals' duties of care and their breach under the securities laws. *Id.* at 860-61 & n.8.

[5] Although the recordation and overencumbrancing evidence was before the Commission, neither fact had been alleged

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into the real property value, and made no investigation into the first trust deed holder's interests in the parks.[6] Thus, the Commission concluded Petitioners' recommendations were recklessly made. Their failure to investigate created a substantial risk that their representations were false, "which must have been obvious" to Petitioners. Uncontroverted evidence of Petitioners' subjective, good faith beliefs could not overcome this finding because the Commission rejected it as objectively unreasonable and implausible. Petitioners were therefore "legally bound as knowing [their] representations were false." (App., *infra*, 43a-47a).

The Ninth Circuit affirmed, finding that the Commission "considered all of the evidence bearing on [Petitioners'] actual state of mind." An inference of reckless scienter arose because Petitioners made no effort to investigate why clients were sold second (and not first) trust deeds, identify first trust deed holders, ensure the trust deeds were actually recorded, or corroborate Archer's statements. It upheld the decision to reject Petitioners' uncontroverted good faith evidence offered in rebuttal. The inference of scienter

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by NASD. Petitioners raised this issue below, but the Ninth Circuit deemed it waived (App., *infra*, 21a).

[6] The Commission's scienter findings were based in part on the following: "[i]t is also unclear whether there may have been other second trust holders who, by virtue of having recorded their interests first in time, would have priority over [Note] purchasers. There is no evidence that [Petitioners] considered or investigated this possibility" (App., *infra*, 46a).

remained unrebutted and the Commission's findings were upheld (App., *infra*, 9a-21a).

REASONS FOR GRANTING THE PETITION

In the decision below the Ninth Circuit articulated a novel standard that predicates §10(b) and Rule 10b-5 liability on reckless conduct despite an uncontroverted showing of subjective good faith. It held Petitioners liable upon a finding that their failure to conduct a "meaningful investigation" rendered their representations concerning the Notes' merit false and reckless. Petitioners were unable to rebut the inference because otherwise uncontroverted evidence of their subjective good faith beliefs was rejected as deemed objectively unreasonable and implausible. Yet this recklessness standard, like others, is contrary to §10(b)'s purpose: proscribing "knowing or intentional misconduct" and practices "other than in good faith." *Hochfelder*, 425 U.S. at 197, 206.

In addition; the decision below rests on other lower court decisions that are contrary to this Court's precedent. These Circuits' recklessness standards are not the product of the statutory analysis mandated by *Hochfelder* and its progeny. Indeed, equating reckless conduct with scienter calls for a standard of care analysis, which is inconsistent with *Hochfelder's* requirement of proof of an intent to deceive. *Merck*, slip op. at 13.

Furthermore, the decision below exacerbates a fractured conflict among the Circuits. While the Circuits have largely adopted a single definition of §10(b) recklessness, at least five distinct tests may be discerned from their case law. Further conflict exists over good faith. Such conflict breeds uncertainty. Uncertainty harms market participants because they face the possibility of ruinous, expensive litigation, perpetuated by decisional law that offers little predictive guidance for their conduct. Uncertainty also harms investors because such litigation increases the cost of, and diminishes the return to, capital. Increased costs and losses are born by investors, a perverse result, given the Securities Acts' purposes.

A. This Case Is A Proper Vehicle To Resolve The Open Question Of Whether Reckless Conduct Satisfies The Scienter Element.

Petitioners seek review of the Ninth Circuit's conclusion that reckless conduct, despite subjective good faith, satisfies §10(b) scienter. This Court has expressly left open the question. *Hochfelder*, 425 U.S. at 193 n.12; *Aaron*, 446 U.S. at 686 n.5; *Tellabs*, 551 U.S. at 319 n.3. On at least one occasion it has found the issue appropriate for review by a writ of certiorari, only to decide the matter on a different ground. *Compare Central Bank, N.A. v. First Interstate Bank, N.A.*, 508 U.S. 959 (1993) (granting certiorari on recklessness and aiding and abetting) *with Central Bank, N.A. v. First Interstate Bank, N.A.*, 511 U.S. 164 (1994) (resolving aiding and abetting only),

superseded on other grounds by the PSLRA as stated in *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 162 (2008). Although it holds that §10(b) does not reach good faith conduct, *Hochfelder*, 425 U.S. at 206, this Court has yet to address the subsidiary question of whether, and to what extent, good faith is a defense to scienter.

The court below, like others before it, answered *Hochfelder's* open questions but lost sight of its central teaching, which was "to reinforce and clarify the distinction between ordinary malpractice resting on negligence, on the one hand, and fraud, on the other." *Pegasus Fund, Inc. v. Laraneta*, 617 F.2d 1335, 1340 (9th Cir. 1980) (citing *Hochfelder*, 425 U.S. at 200). Indeed, the Circuits inferred unqualified approval of a recklessness standard from this Court's silence despite *Hochfelder's* reasoning. *See, e.g., Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 44 (2d Cir. 1978) ("[B]y leaving open the possibility that recklessness might satisfy the scienter requirement, the Supreme Court recognized that in certain instances a recklessness standard might be appropriate.").

This case presents the Court with the perfect vehicle to resolve *Hochfelder's* meaning. Petitioners do not ask the Court to police the scope of the implied private remedy under Rule 10b-5. *See, e.g., Blue Chip Stamps*, 421 U.S. at 736 n.8. Nor do they question pleading standards under the Private Securities Reform Litigation Act. *See, e.g., Tellabs*, 551 U.S. at 322. Instead, Petitioners ask the Court to review a

§10(b) matter expressly contemplated by Congress: a disciplinary action brought by the Commission against securities professionals. Dispositive of this matter is the quantum of culpability for §10(b) scienter and the subsidiary, but interrelated, issue of good faith. In considering these issues, the Court will have the benefit of a full and complete record below.[7]

Litigation under §10(b) and Rule 10b-5 "presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general." *Central Bank*, 511 U.S. at 189 (quoting *Blue Chip Stamps v. Manor Drug Stores,* 421 U.S. 723, 739 (1975)). Indeed, the volume of such litigation, coupled with decades of erratic interpretation by the lower courts, frustrate §10(b)'s and Rule 10b-5's purposes. *See* COHN, *supra*, at §19:8; SECURITIES FRAUD, *supra*, at §2:29.

It is therefore critically important that this Court, as the ultimate expositor of federal law, clarify that *Hochfelder* and the unresolved issue of reckless §10(b) scienter.

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[7] Petitioners do not intend for the Court to undertake a factual review of the decisions below. Rather, Petitioners suggest the Court's evaluation of scienter issue will be aided by a full record, as opposed to the record one might find at the pleading stage.

B. The Decision Below, And Other Decisions It Relies Upon, Were Decided In A Manner Contrary To *Hochfelder* And Its Progeny.

This Court set forth a statutory analysis for determining §10(b) scienter in *Hochfelder* and its progeny. As in the decision below, the lower courts have strayed from that analytical framework and adopted a recklessness standard predicated on opaque and unfounded common law concepts, policy considerations, and administrative law principles.

Hochfelder makes clear that in questions concerning §10(b), statutory construction is paramount. The Court's examination of the language and legislative history of §10(b) and the 1934 Act, revealed that, by using the terms "manipulative or deceptive device or contrivance," Congress "intended to proscribe knowing or intentional misconduct" only, *i.e.*, practices "other than in good faith." 425 U.S. at 197, 206. To that end, a violation of §10(b) requires proof of "scienter," defined as "a mental state embracing intent to deceive, manipulate, or defraud." *Id.* at 193 n.12, 199. The Court underscored that liability cannot be extended beyond the text of §10(b), and policy considerations, such as the Securities Acts' "broad remedial purpose," or administrative rules, including Rule 10b-5, cannot be used to expand the statute's scope. *Id.* at 200-03, 212-14 & n.33.

The Court extended *Hochfelder* to all §10(b) claims and proceedings in *Aaron*. 446 U.S. at 690. *Aaron* construes *Hochfelder* as setting forth a very

specific framework to determine §10(b) scienter questions, namely courts are to look to: (1) "the plain meaning of the language of §10(b)"; (2) "the legislative history of §10(b)"; and (3) "the structure of the civil liability provisions in the 1933 and 1934 Acts." *Aaron*, 446 U.S. at 690. As in *Hochfelder*, policy considerations are immaterial if these three factors are dispositive. *Id.* at 695.

Later cases have developed these principles and refined this statutory analysis. The Court has reiterated *Hochfelder's* definition of scienter several times. *See, e.g., Dirks v. SEC*, 463 U.S. 646, 664 n.23 (1983); *Central Bank,* 511 U.S. at 173; *Tellabs*, 551 U.S. at 313; *Merck,* slip op. at 11. Construction of §10(b) remains the starting (and often, end) point in the analysis. *See, e.g., Central Bank,* 511 U.S. at 173; *Chiarella v. United States*, 445 U.S. 222, 226 (1980). Like Rule 10b-5, the common law may not be used to expand the scope of §10(b) liability. *Santa Fe Indus. v. Green*, 430 U.S. 462, 472-73 (1977). Thus, conduct is actionable only if it is "manipulative or deceptive" within §10(b)'s meaning. *Id.* at 475-77 & n.15 (breach of fiduciary duty, without more, insufficient). "Congress, in enacting [§10(b)], did not intend to provide a broad federal remedy for all fraud." *Marine Bank v. Weaver*, 455 U.S. 551, 556 (1982). As such, it is improper to construe §10(b) by looking to the common law, even as it existed in 1934. *Central Bank,* 511 U.S. at 181-85.

The reasoning underlying the decision below can be traced to two lines of authority concerning reckless

scienter: the Seventh Circuit's *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033 (7th Cir. 1977), and the Second Circuit's *Hanly v. SEC*, 415 F.2d 589 (2d Cir. 1969). Neither is faithful to *Hochfelder* or its progeny.

Sundstrand is the "majority rule" among the Circuits and represents an approach that looks to the common law and policy considerations to decide scienter questions. The Seventh Circuit did not consult the text of §10(b), its legislative history, or the structure of the securities acts as a whole. Instead, it rationalized that because *Hochfelder* did not signal a "radical departure" from Rule 10b-5 case law, §10(b) should be interpreted coextensively with the common law of fraud and deceit and "accepted Rule 10b-5 principles." *Sundstrand*, 553 F.2d at 1044. Looking to Justice Holmes' 1885 treatise on the common law,[8] it determined that, notwithstanding evidence of good faith, a finding of recklessness was conclusive as to liability. *Id.* at 1045.

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[8] According to Holmes, fraud liability may be premised on objectively reckless conduct, "whatever [the actor's] state of mind, and although he individually may have been perfectly free from wickedness." O. HOLMES, THE COMMON LAW 92-93 (ABA 2009). Holmes' view is contrary to this Court's common law fraud precedent, which holds that a genuine belief, even one based on insufficient grounds, is an affirmative defense to fraud. *See Tucker v. Moreland*, 35 U.S. (10 Pet.) 58, 78 (1836); *see also Derry v. Peek*, 14 App. Cas. 337, 352 (Gr. Brit. 1889) (objectively reckless conduct gives rise to inference of scienter, which may be rebutted by subjective good faith).

The Tenth Circuit adopted *Sundstrand* in *Hackbart v. Holmes*, 675 F.2d 1114, 1117-18 (10th Cir. 1982), which is notable for its survey of the Circuit's recklessness decisions post-*Hochfelder*. It agreed with the Sixth Circuit that the remedial purposes of the securities laws favored a recklessness standard. *Id.* at 1117. It also agreed with Second, Fifth, and Sixth Circuits that recklessness would be sufficient because an intent requirement "would be unduly burdensome" to plaintiffs. *Id.* at 1118. Finally, it agreed with the Sixth and Seventh Circuits' conclusion that recklessness suffices because §10(b) proscribes fraudulent practices similar to the common law, and there, recklessness is often sufficient. *Id.* at 1118; *see Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1569 n.7 (9th Cir. 1990) (adopting *Sundstrand* in part to create "greater uniformity" between circuits).

Hanly looked to the Commission's administrative proceedings[9] to develop a theory of §10(b) liability based on the breach of a securities professional's standard of care. In *Hanly*, the Second Circuit imported the Commission's so-called "shingle theory"[10] into

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[9] Before *Hochfelder*, the Second Circuit reasoned it was proper to look outside of legislative sources to construe §10(b) because Rule 10b-5 had "moved far from its original moorings." *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1299 (2d Cir. 1973), superseded on other grounds by the PSLRA as stated in *Lapin v. Goldman Sachs Group, Inc.*, 506 F.Supp.2d 221, 249 (S.D.N.Y. 2006).

[10] Three years before it promulgated Rule 10b-5, the Commission developed its implied representation, or "shingle" theory

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§10(b) contexts, which it converted into "implied assertion" theory of liability for securities professionals. 415 F.2d at 596. "Shingle theory" has been codified in professional rules of conduct, such as NASD Rule 2110, and does not require a showing of scienter (App., *infra*, 209a).

After *Hochfelder*, the Second Circuit revised *Hanly's* implied assertion theory to require a showing of at least reckless conduct, but applies to any fiduciary of a defrauded party. *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d at 44, and *see SEC v. Dain Rauscher, Inc.*, 254 F.3d 852, 857-58 (9th Cir. 2001) (extending broker-dealer implied assertion liability to underwriters).

The decision below merges these lines of authority by articulating a rebuttable-inference analysis based on *Sundstrand*, in which *Hanly* defines the relevant standard of care. Like *Sundstrand*, it looks to common law sources to hold that the plausibility of a defendant's subjective good faith belief is determined with reference to a "reasonable person" standard (App., *infra*, 11a-15a, 19a-20a, 64a). Like *Hanly*, it

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in an administrative proceeding. *Duker & Duker*, 6 S.E.C. 386 (1939). "Inherent in the relationship between a dealer and his customer is the vital representation that the customer will be dealt with fairly, and in accordance with the standards of the profession." *Id.* at 388. By the mere act of hanging out his or her shingle, the market professional impliedly warrants fair dealing. *See id.* at 388 n.5. Shingle theory was first recognized under §15 of the 1934 Act by the Second Circuit in *Charles Hughes & Co. v. SEC*, 139 F.2d 434, 436-37 (2d Cir. 1943).

looks to administrative law, specifically, deference principles, to determine that the Commission is entitled to reject subjective good faith evidence if it is implausible[11] (App., *infra*, 64a). As such, the Ninth Circuit announced a novel standard[12] for determining scienter by relying on authority inconsistent with, if not contrary to, *Hochfelder* and its progeny.

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[11] *Gebhart I* instructed that under principles of *Skidmore* deference, the Commission may reject Petitioners' subjective good faith evidence as "implausible." This is erroneous. *Skidmore* deference affords weight to an agency's informal interpretations of law proportional to its "power to persuade." *United States v. Mead Corp.*, 533 U.S. 218, 234-235 (2001). Under the Administrative Procedures Act, 5 U.S.C. §554, et seq., the Commission's factual findings are reviewed for "substantial evidence." *See Steadman v. SEC*, 450 U.S. 91, 96-102 (1981). *Gebhart I* does not explain how the Commission's findings of fact constitute persuasive legal interpretation.

[12] *Gebhart II's* novel standard effectively creates an irrebutable inference of scienter because it permits the Commission to reject subjective good faith evidence offered to rebut an inference of scienter – *even if uncontroverted* – when it deems such evidence "implausible," *i.e.*, objectively unreasonable. *Compare SEC v. Rubera*, 350 F.3d 1084, 1094-96 (9th Cir. 2003) (summary judgment upheld because scienter inference rebutted by uncontroverted evidence). Crafting such a standard without reference to Congressional intent is dubious, at best. *See Usery v. Turner Elkhorn Mining Co.*, 428 U.S. 1, 22-24 (1976), superseded on other grounds by statute as stated in *McDonnell v. City of Omaha*, 999 F.2d 293 (8th Cir. 1993) (conclusive presumptions based on Congressional determination that no contrary evidence should be allowed as a matter of overriding social policy); *see also Vlandis v. Kline*, 412 U.S. 441, 453 (1973) (irrebuttable presumption of fact violates due process).

The decision below, like the cases it relies on, did not employ *Hochfelder's* statutory analysis when it formulated its new test standard. Instead, these decisions ground their reckless conduct standards on common law, policy considerations, administrative law, and legal commentary. Yet *Hochfelder* and its progeny expressly hold that resort to such sources is improper when, as now, §10(b)'s text is clear.

This error is compounded by the lower court's application of implied assertion theory and its reasonable investigation standard of care (App., *infra*, 16a-17a, 64a). Negligence is never sufficient under §10(b), "regardless of the identity of the plaintiff or the nature of the relief sought." *Aaron*, 446 U.S. at 691. Requiring a greater quantum of carelessness is not a principled solution because "the line between gross negligence and recklessness is a fine one at best." *Board of County Comm'rs v. Liberty Group*, 965 F.2d 879, 884 (10th Cir. 1992). Implied assertion liability is also contrary to *Santa Fe*, which holds that careless conduct must itself be "manipulative or deceptive" to trigger §10(b). 430 U.S. at 475-77 & n.15.

In truth, reckless scienter tests, as a whole, are inconsistent with this Court's §10(b) case law. "[R]ecklessness in securities fraud is an untidy, case-by-case concept." *Helwig v. Vencor, Inc.*, 251 F.3d 540, 551 (6th Cir. 2001), *overruled on other grounds by Tellabs*, 551 U.S. at 324. It necessarily requires a fact-intensive inquiry, which "belies the existence of a bright line test for when the scienter threshold has been crossed." *Dolphin & Bradbury, Inc. v. SEC*, 512

F.3d 634, 639 (D.C. Cir. 2008). Such an inquiry is not a "satisfactory basis for a rule of liability imposed on the conduct of business transactions." *Central Bank*, 511 U.S. at 188 (quoting *Blue Chip Stamps*, 421 U.S. at 755). At best, "[t]he issues would be hazy, their litigation protracted, and their resolution unreliable. Given a choice, [this Court] would reject any theory . . . that raised such prospects." *Id.* at 189 (quoting *Virginia Bankshares v. Sandberg*, 501 U.S. 1083, 1106 (1991)).

Because the Circuits, including the court below, decided an important federal question in a manner contrary to *Hochfelder* and its progeny, certiorari should be granted.

C. The Decision Below Conflicts With Other Circuits' §10(b) Recklessness Case Law.

Certiorari is also warranted because the standard articulated in the decision below conflicts with other Circuits' §10(b) recklessness standards. Application of these divergent standards to the same facts results in liability in some jurisdictions, but not in others. *Tellabs* suggests as much: "Every [Circuit] that has considered the issue has held that a plaintiff may meet the scienter requirement by showing that the defendant acted intentionally or recklessly, though the Circuits differ on the degree of recklessness required." *Id.*, 551 U.S. at 319 n.3.

However, the conflict is as much a question of degree as it is of kind. For example, the Seventh

Circuit warns that recklessness should not be defined liberally, "lest any discernible distinction between 'scienter' and 'negligence' be obliterated." *Sanders v. John Nuveen & Co.*, 554 F.2d 790, 793 (7th Cir. 1977). In contrast, the Sixth Circuit recognizes there is "little analytical value in deciding precisely where along this spectrum recklessness falls," because "what constitutes reckless behavior . . . is ultimately a factual determination which will necessarily vary from case to case." *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1024-1025 & n.36 (6th Cir. 1979), superseded on other grounds by the PSLRA as stated in *Burns v. Prudential Sec.*, 116 F.Supp.2d 917, 925 (N.D. Ohio 2000).

Although the Circuits purport to apply the same definition of recklessness, a close examination of their precedents reveals at least five categories of recklessness standards that differ both in degree and kind: (a) *Sundstrand*; (b) implied assertion liability; (c) common law "reckless disregard"; (d) "severe recklessness"; and (e) intentional recklessness. The first three tests pay lip service to *Hochfelder*, while the latter two standards remain somewhat more faithful to its principles.

The majority standard[13] comes from *Sundstrand*:

> [R]eckless conduct may be defined as a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.

553 F.2d at 1045.

Sundstrand has objective and subjective components. *Id.* The objective component looks to the breach of the standard of care, while the subjective component requires that the breach be "something more egregious than even 'white heart/empty head' good faith." *Id.* at 1045 & n.20. It is unclear, however, whether this subjective component is a truly separate analytical step. *See Makor Issues & Rights, Ltd. v. Tellabs Inc.*, 513 F.3d 702, 704 (7th Cir. 2008) ("[*Sundstrand*] looks like two criteria – knowledge of the risk and how big the risk is -- but as a practical matter it is only one because knowledge is inferable from gravity.").

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[13] *Sundstrand* has been adopted by the First, Third, Seventh, Ninth, Tenth, and D.C. Circuits. *Cook v. Avien, Inc.*, 573 F.2d 685, 692 (1st Cir. 1978); *McLean v. Alexander*, 599 F.2d 1190, 1198 (3d Cir. 1979); *Hollinger*, 914 F.2d at 1568-70; *SEC v. Steadman*, 967 F.2d 636, 641-42 (D.C. Cir. 1992).

The implied assertion theory of recklessness springs from the Second Circuit's decision in *Hanly*, which holds that §10(b) liability can be imposed on a securities professional based on his or her "implied warranty" of a recommended investment. 415 F.2d at 596. Under *Hanly*, a securities professional impliedly warrants that he or she has an adequate basis to recommend a security, based on the professional's duty to conduct a "meaningful", *i.e.*, reasonable, investigation of the security. *Id.* at 596-97. The reasonableness of an investigation is determined case-by-case and security-by-security. *Id.* at 596. As in the decisions below, a breach of this duty of care makes the professional's implied assertions concerning his or her recommendation false, resulting in a reckless violation of §10(b) (App., *infra*, 16a-17a, 64a). *See also Rolf*, 570 F.2d at 44; *Dain Rauscher*, 254 F.3d at 857-58.

The Sixth Circuit and, on occasion the Second and Ninth Circuits, apply a common law "reckless disregard" test. Under this test, recklessness is not intentional; rather it "falls somewhere between intent and negligence." *Mansbach,* 598 F.2d at 1025 n.36; *IIT, International Inv. Trust v. Cornfeld*, 619 F.2d 909, 923 (2d Cir. 1980) (reckless disregard); *Vernazza v. SEC*, 327 F.3d 851, 860 (9th Cir. 2003) ("'knowing or reckless conduct,' without a showing of 'willful intent to defraud.'")

Other courts use the "severe recklessness" test.[14] Severe recklessness is essentially "a slightly lesser species of intentional misconduct." *See Ottmann v. Hanger Orthopedic Group, Inc.*, 353 F.3d 338, 344 (4th Cir. 2003). Although it incorporates *Sundstrand*, "severe recklessness" attempts to satisfy *Hochfelder* by effectively requiring proof of actual intent, knowledge, or bad faith. *See Huddleston v. Herman & MacLean*, 640 F.2d 534, 545 (5th Cir. Unit A 1981), *aff'd in relevant part*, 459 U.S. 375 (1983) ("conduct which is so extreme as to be a form of intentional conduct or behavior equivalent to an intent to deceive, manipulate or defraud").

Some courts construe *Hochfelder* to permit an intentional or deliberate recklessness standard. *See Chill v. GE,* 101 F.3d 263, 269 (2d Cir. 1996) ("egregious refusal to see the obvious, or to investigate the doubtful"); *SEC v. Jakubowski*, 150 F.3d 675, 681-82 (7th Cir. 1998) ("deliberate ignorance"); *SEC v. Rubera*, 350 F.3d 1084, 1094 (9th Cir. 2003) (recklessness must reflect "some degree of intentional or conscious misconduct"). The Southern District of New York articulates this standard best: "reckless conduct constitutes fraud only where a defendant 'deliberately refrained from taking steps to discover whether [its]

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[14] The Fourth, Fifth, Eighth, and Eleventh Circuits have adopted "severe recklessness." *Ottmann*, 353 F.3d at 344; *Lowry v. SEC,* 340 F.3d 501, 506 (8th Cir. 2003); *McDonald v. Alan Bush Brokerage Co.*, 863 F.2d 809, 814 (11th Cir. 1989); *Broad v. Rockwell Int'l Corp.*, 642 F.2d 929, 961-62 (5th Cir. 1981).

statements were false or misleading.'" *In re CBI Holding Co.*, 419 B.R. 553, 567 (S.D.N.Y. 2009) (quoting *In re Fischbach Corp. Sec. Litig.*, 1992 U.S. Dist. LEXIS 373 *14 (S.D.N.Y. 1992)).[15]

The subsidiary issue of good faith also creates sharp conflicts. As noted, *Hochfelder* concluded that Congress did not intend for anyone to be made liable except for practices "acted other than in good faith." 425 U.S. at 206. Comparing the Senate and House reports[16] revealed an "overall congressional intent to prevent 'manipulative and deceptive practices'" and to create private actions for damages "where the

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[15] *Fischbach* explains that recklessness "is a form of intentional conduct if the defendants deliberately refrained from taking steps to discover whether their statements were false or misleading, but . . . it is not a form of intentional conduct if the defendants' failure to investigate was not deliberate." 1992 U.S. Dist. LEXIS 373 at *14-15. Thus, where a "defendant deliberately shut his eyes to the truth, the scienter requirement is met." *Id.* at *19.

[16] The Senate committee report explained that Section 9 "provides that any person who . . . induces transactions in a security by means of false or misleading statements . . . shall be liable in damages to those who have bought or sold the security at prices affected by such violation or statement. In such case the burden is on the plaintiff to show the violation or the fact that the statement was false or misleading, and that he relied thereon to his damage. The defendant may escape liability by showing that the statement was made in good faith." *Hochfelder*, 425 U.S. at 205-06 (quoting S. Rep. No. 792, 73d Cong., 2d Sess., 12-13 (1934); H.R. Rep. No. 1383, 73d Cong., 2d Sess., 10-11, 20-21 (1934)).

defendant has not acted in good faith." *Id.* As such, "§10(b) should be interpreted no more broadly." *Id.*

Panels in the Second, Third, and Seventh Circuits hold that a finding of recklessness is conclusive as to liability and, as a result, good faith provides no defense. *Sundstrand,* 553 F.2d at 1044 n.17; *Rolf,* 570 F.2d at 46. The fullest expression of this thinking is found in *SEC v. Infinity Group Co.*, 212 F.3d 180 (3d Cir. 2000). There, the Third Circuit strenuously, if not categorically, rejected the defendants' good faith contentions because "[a] good faith belief is not a 'get out of jail free card.' It will not insulate the defendants from liability if it is the result of reckless conduct."[17] *Id.* at 193. *Infinity Group* represents a triumph of objective reasonableness over subjective good faith in failure-to-investigate cases contrary to *Hochfelder*: "We will assume that a defendant can genuinely have a subjective belief that demonstrates good faith even though it is the result of reckless conduct. However, it clearly can be argued that a subjective belief based only upon an inquiry that is reckless can never properly be considered a 'good faith' belief." *Id.* at 193 n.16; *cf.* 4 SECURITIES FRAUD, §7:128 (application of

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[17] This is incorrect: good faith is always a defense to criminal securities fraud charges. *See United States v. Weiner*, 578 F.2d 757, 786-87 (9th Cir. 1978) (absolute defense); *United States v. Teicher*, 987 F.2d 112, 121 (2d Cir. 1993) (same); *cf. United States v. Peterson*, 101 F.3d 375, 381 (5th Cir. 1996) (proves absence of scienter).

care criteria, as opposed to intent or knowledge, equates negligence with fraud).

Other courts hold that good faith is a defense to §10(b) reckless scienter. Indeed, the First Circuit states that it would be "manifestly incorrect" to hold otherwise. *Hoffman v. Estabrook & Co.*, 587 F.2d 509, 513 n.7 (1st Cir. 1978). However, there is no consensus among these courts. On the one hand, some hold that where the evidence as a whole demonstrates good faith, scienter is not present. *See, e.g., State Teachers Retirement Bd. v. Fluor Corp.*, 654 F.2d 843, 851 (2d Cir. 1981); *Law v. Medco Research, Inc.*, 113 F.3d 781, 784-85 (7th Cir. 1997); *Broad v. Rockwell Int'l Corp.*, 642 F.2d 929, 961-62 (5th Cir. 1981) (en banc). Indeed, negligent good faith necessarily disproves scienter. *Wertheim & Co. v. Codding Embryological Sciences, Inc.*, 620 F.2d 764, 766-67 (10th Cir. 1980).

On the other hand, some courts hold that good faith, while not a formal defense to liability, may rebut an inference of scienter. For example, good faith explanations rebut any inferences of scienter drawn from insiders' suspicious trading. *Kaplan v. Rose*, 49 F.3d 1363, 1379-81 (9th Cir. 1994) superseded on other grounds by statute as stated in *Hockey v. Medhekar*, 30 F.Supp.2d 1209, 1215 (N.D. Cal. 1998). Similarly, a finding of due diligence rebuts any inference of scienter. *In re Software Toolworks Inc.*, 50 F.3d 615, 626-27 (9th Cir. 1994); *Univ. Hill Foundation v. Goldman, Sachs & Co.*, 422 F.Supp. 879, 898 (S.D.N.Y. 1976). Good faith reliance on the advice of

counsel may also rebut such an inference. *See SEC v. National Student Marketing Corp.*, 457 F.Supp. 682, 712 n.68 (D.D.C. 1978) (reliance on counsel's silence insufficient).

The end result is that: "[o]ne judge may deem an accused party to have acted recklessly, while a different judge in another case may exonerate a defendant charged with nearly identical misconduct." K. Johnson, *Liability for Reckless Misrepresentations and Omissions under Section 10(b) of the Securities Exchange Act of 1934*, 59 U. CIN. L. REV. 667, 674-75 (1991). One need only look to the administrative proceedings below to find ample support for this conclusion.

The Hearing Panel mixed implied assertion and "severe recklessness" standards and found no scienter (App., *infra*, 207a-209a). NAC applied *Sundstrand* and found reckless scienter. It rejected Petitioners' subjective good faith evidence per *Infinity Group* (App., *infra*, 164a-171a). Relying only on implied assertion cases, the Commission found scienter in its first review (App., *infra*, 115a-122a).

On remand, the Commission found that as a result of the Petitioners' unreasonable investigation,[18]

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[18] As noted, the Commission based its scienter finding in part on unknown facts. *See, supra,* note 6. Because there is no indication Petitioners' statements were false or misleading in this regard, such "facts" cannot support a scienter finding. *See Santa Fe Indus.*, 430 U.S. at 475-77 & n.15.

they "[were] legally bound as knowing [their] representations were false." (App., *infra*, 64a). By objectively assessing Petitioners' subjective good faith beliefs, the Commission effectively applied a *Hanly*-like negligence standard, despite purporting to follow *Sundstrand*.[19]

Indeed, the decision below is inconsistent with other decisions on the same or similar facts. The Ninth Circuit ostensibly applied *Sundstrand* below to affirm the Commission's scienter findings based on Petitioners' failure to conduct a "meaningful investigation" (App., *infra*, 16a). Similarly, a broker's unreasonable investigation always warrants liability in implied assertion jurisdictions. *Rolf*, 570 F.2d at 44. However, the same conduct, without more, proves negligence, not recklessness under the "severe recklessness" test. *McDonald*, 863 F.2d at 815 (disapproving implied assertion theory). Indeed, in a similar case involving notes secured by mortgages on a real estate development, the Eighth Circuit found scienter under the "severe recklessness" test, but only because the defendants failed to investigate any aspect of the investments, which were structurally incapable of benefitting investors, and defendants

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[19] The Commission did not cite *Hanly* in its second decision. However, its strategic application of *McLean*, *Infinity Group*, *Makor Issues* and HOLMES, *supra*, yielded a wholly objective analysis that precludes subjective good faith evidence and finds scienter on nothing more than an unreasonable investigation (App., *infra*, 6). *Hanly* is functionally indistinguishable.

otherwise displayed a "total disregard of their obligation[s] as professional securities salesmen to the public." *See Feeney v. SEC*, 564 F.2d 260, 262 (8th Cir. 1977). It is safe to conclude that Petitioners' investigation, such as it was, would have forestalled liability in "severe recklessness" jurisdictions.

What is more, even these principles are not uniformly applied to all securities professionals. The Circuits apply different standards based on job functions, *e.g.*, brokers and underwriters, and those standards are also conflicting. The Ninth Circuit holds that underwriters subject to implied assertion liability. *Dain Rauscher,* 254 F.3d at 858-59. In contrast, the Seventh Circuit holds that an underwriter cannot not be held liable under §10(b) "on [a] theory that it breached a duty to make reasonable inquiries"; such conduct is negligence. *Sanders,* 554 F.2d at 792-93, 796. The same is true under a "willful blindness" standard. *See In re Crazy Eddie Sec. Litig.*, 817 F.Supp. 306, 312-17 (E.D.N.Y. 1993) (underwriters' investigation not actionable; reliance on outside auditor's "comfort letters" negligent, not reckless). Finally, the First Circuit expressly rejected *Dain Rauscher*: "a breach of a duty to investigate, without more," is simply not equivalent to an actionable "breach of a duty to disclose." *SEC v. Tambone*, 597 F.3d 436, 447-48 (1st Cir. 2010).

At best, these recklessness standards promise "a shifting and highly fact-oriented disposition of the [scienter] issue." *Central Bank*, 511 U.S. at 188. At worst, the standards inject systemic ambiguity into

"an area that demands certainty and predictability." *Id.* (quoting *Pinter v. Dahl*, 486 U.S. 622, 652 (1988)). "That leads to the undesirable result of decisions made on an ad hoc basis, offering little predictive value to those who provide services to participants in the securities business." *Id.* (internal quotation marks omitted). "Because of the uncertainty of the governing rules, entities subject to [liability] may find it prudent and necessary, as a business judgment, to abandon substantial defenses and to pay settlements in order to avoid the expense and risk of going to trial." *Id.* at 189.

Nor is the harm limited to defendants. Reckless standards perversely "exact[ ] costs that may disserve the goals of fair dealing and efficiency in the securities markets." *Id.* at 188. "Unnecessary civil or criminal liability diminishes the return to, and increases the cost of, capital." Winter, *Paying Lawyers, Empowering Prosecutors, and Protecting Managers: Raising the Cost of Capital in America*, 42 DUKE L.J. 945, 948 (1993) (cited with approval by *Central Bank*, 511 U.S. at 189). These costs are passed on to "investors, the intended beneficiaries of the statute." *Central Bank*, 511 U.S. at 189.

"[T]here can be no certainty on the subject until the Supreme Court fleshes out [*Hochfelder*]." *IIT*, 619 F.2d at 923. Until then, the Circuits will "continue to follow [their] own decisions." *Id.* Certiorari should issue to remedy the state of the law.

CONCLUSION

This petition for a writ of certiorari should be granted.

Respectfully submitted,

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May 18, 2010

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FOR PUBLICATION

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

ALVIN W. GEBHART, JR.; DONNA T. GEBHART,

Petitioners,

v.

SECURITIES AND EXCHANGE COMMISSION,

Respondent.

No. 08-74943

SEC No. CRD1005905

OPINION

On Petition for Review of an Order of the Securities & Exchange Commission

Submitted December 1, 2009*
Pasadena, California

Filed February 17, 2010

Before: Harry Pregerson, Michael Daly Hawkins and Raymond C. Fisher, Circuit Judges.

Opinion by Judge Fisher

COUNSEL

Charles F. Goria, Goria, Weber & Jarvis, San Diego, California, for the petitioners.

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* The panel unanimously finds this case suitable for decision without oral argument. *See* Fed. R. App. P. 34(a)(2).

David M. Becker, Mark D. Cahn, Jacob H. Stillman, Randall W. Quinn, William K. Shirey, Securities and Exchange Commission, Washington, D.C., for the respondent.

OPINION

FISHER, Circuit Judge:

Alvin W. and Donna T. Gebhart petition for review of an order by the Securities and Exchange Commission (SEC) sustaining a disciplinary action by the National Association of Securities Dealers (NASD).[1] The NASD found that the Gebharts, securities salespersons, committed securities fraud in violation of section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 by making false statements to clients in connection with the sale of promissory notes used to finance the conversion of mobile home parks to resident ownership. The SEC upheld the NASD's disciplinary action, concluding that the Gebharts acted with scienter because they made "representations to their clients despite not knowing whether they were true or false." We hold that the SEC applied the correct scienter standard and that substantial evidence supports the SEC's conclusion that the Gebharts acted with scienter. We therefore deny the petition for review.

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[1] The NASD is now the Financial Industry Regulatory Authority (FINRA).

I. BACKGROUND

Alvin Gebhart has been in the securities industry since 1983.[2] In 1994, he began working at Mutual of New York (MONY) in San Diego, where he sold annuities and mutual funds. While at MONY, Gebhart met Jack Archer, a fellow MONY salesperson. In 1995, Archer told Gebhart about a business venture, Community Service Group (CSG), run by James Scovie. CSG was in the business of converting mobile home parks to resident ownership. CSG purchased parks from the owners and then assisted residents in purchasing them. In late 1996, Scovie and another

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[2] In May 1983, Gebhart registered with the NASD as an investment company products and variable contracts representative ("IC representative") with the Prudential Insurance Company of America. In January 1996, he became associated with Mutual Service Corporation (MSC), a NASD member, as an IC representative. In December 1997, he passed the Series 7 general securities representative qualifying examination and became associated with MSC as a general securities representative.

Donna Gebhart registered with the NASD through Pacific Mutual as an IC representative on February 13, 1996. On February 14, 1996, she became associated with MSC as an IC representative. In April 1998, she passed the Series 7 qualifying examination and became associated with MSC as a general securities representative.

In August 2000, MSC terminated the Gebharts' registrations. The Gebharts subsequently registered as general securities principals, general securities representatives and IC representatives with Sentra Securities Corporation, another NASD member. They were associated with Sentra at the time of the NASD disciplinary proceedings that are the subject of this case.

person, David Mounier, created MHP Conversions, LLC (MHP) to facilitate the conversion process. MHP issued promissory notes that were sold to individual investors to raise funds for CSG's purchase of the parks. The MHP notes had one-year terms with fixed interest rates of 18 percent for new investments and 14 percent for reinvested funds. Each note stated that it would "ultimately be secured by a deed of trust" on the particular park to be purchased with the funds, but that "[u]ntil such time as said deed of trust is recorded, the sole asset of [the issuer] will be a deed of trust for the property known as Eastern Trailer Park."

Archer told Gebhart about the MHP program and asked Gebhart whether any of his clients were interested in investing. Gebhart arranged for Archer to make a presentation of the MHP program to three of his clients, all of whom made investments in the program. Archer earned a sales commission, and paid half of the commission to Gebhart.

In early 1996, Gebhart moved from MONY to another financial services firm, Mutual Service Corporation (MSC), a broker-dealer and member of the NASD. His wife, Donna Gebhart, joined him at MSC and the two opened and operated a MSC branch in Rancho Bernardo, California, where they sold insurance and annuities and provided financial planning services to clients. In October 1996, Archer approached the Gebharts about selling MHP notes to their MSC clients. The Gebharts met with Archer for about 40 minutes. Archer told them that the MHP

program had been approved by the compliance officer at Archer's firm, MONY. This was not true, however. Archer also told the Gebharts "that the parks were in good shape and he always assured us that they had a lot of equity in them. He said they [were] 45 to 55 percent leveraged."

The Gebharts conducted no independent investigation into the MHP program, either in 1996 or over the next four years, during which time they sold MHP notes to their clients. They failed to obtain any financial statements for CSG or MHP, ascertain who were the owners, officers or shareholders of CSG or MHP, determine what compensation would be paid to CSG or MHP or their officers, verify that trust deeds securing the notes were being recorded or obtain copies of recorded trust deeds. They visited two of the mobile home parks subject to the notes, but those visits do not appear to have served any useful purpose. When Archer would approach the Gebharts with the opportunity for clients to invest in a new park conversion, they conducted no independent analysis of the park in question. Rather, "[i]t was always our understanding that they wouldn't have done a conversion on a park that wasn't – had good cash flow and that would be a deal worth them doing." Although the Gebharts believed that their clients' loans would be secured by second trust deeds, they did not inquire why they were not first trust deeds or who held the first trust deeds. In lieu of an independent investigation, the Gebharts relied on Archer's representations. As Alvin Gebhart explained:

> Throughout our four-year relationship, Mr. Archer continually stressed the strength of this program. Even in February [2000] when he spoke to Mr. Dave Mounier, the other principal [in MHP], he indicated that the parks were deep with equity. Donna and I had continuously interviewed Mr. Archer about the economics of this program. Initially, we were assured that the parks were financed only to 55% of value. Moreover, the monthly rents paid by the homeowners supplied working capital to Community Service Group. Indeed, we were assured that Community Service Group would not even consider a conversion of a park unless it had sufficient rents to pay all costs and interest to the Noteholders.

Donna Gebhart confirmed that she and her husband had simply relied on Archer's representations about the MHP program:

> [Archer] basically explained the program [at the October 1996 meeting]. I don't remember all of the details, but he went over it and I just wanted to be sure that – I wanted to make sure that these notes or trust deeds were secured and he assured us many times that they were always secured. . . . I remember he sort of went through the program. I don't remember word-for-word what the man said, but he came to us and he was a pension administrator, a Pacific Life former manager, and we always looked at him as being probably further up in the – obviously more experienced in stuff than we had.

Between the Gebharts' meeting with Archer in October 1996 and CSG's collapse in 2000, the Gebharts sold nearly $2.4 million in MHP promissory notes to 45 of their clients, earning about $105,000 in commission fees.[3] The sales were based on several statements by the Gebharts that, it later became clear, were false. The Gebharts told their clients that the MHP notes were a proven investment that offered substantial returns and were secured by recorded deeds of trust. They said that in the worst case scenario their clients would be part owners of the mobile home parks and would be able to recover their investments. In fact, the trust deeds were not recorded and the parks were significantly overencumbered. The Gebharts failed to disclose that their statements were based on information provided by Archer rather than their own, independent investigation.

CSG and MHP collapsed in the middle of 2000. In May, Scovie sent a letter to MHP noteholders explaining that an illness was forcing his absence from MHP and CSG. He disclosed that few of the deeds of trust purportedly securing the notes were recorded. In fact, there were approximately $3,670,000 in outstanding promissory notes, of which only $605,000 were secured by recorded deeds of trust. Gebhart admitted that "none of our clients' notes were recorded,"

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[3] The Gebharts also invested thousands of dollars of their own funds in the notes between 1996 and 1999.

and that the mobile home parks turned out to be "substantially overencumbered." At the time of MHP's collapse, the Gebharts' clients had over $1.5 million invested in outstanding MHP notes.[4] MSC terminated the Gebharts' employment in August 2000.

As a result of these events, in 2002 the NASD's Department of Enforcement filed a complaint against the Gebharts for securities fraud.[5] The NASD asserted that the Gebharts had made materially false and misleading statements to their clients, in violation of section 10(b) of the Securities Exchange Act of 1934, SEC Rule 10b-5 and NASD Conduct Rule 2120.[6] A NASD hearing panel found that the Gebharts had acted in good faith and therefore rejected the fraud charges, but the NASD National Adjudicatory Council (NAC) reversed. The NAC found that the Gebharts had committed fraud, imposed a lifetime bar on Alvin

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[4] The Gebharts' clients pursued a number of remedies, with the apparent support of the Gebharts, and were eventually able to recover about 84 percent of their investments.

[5] In addition to the fraud claims, the NASD complaint alleged that the Gebharts had offered and sold unregistered securities, in violation of NASD Conduct Rule 2110, and engaged in private securities transactions, in violation of Conduct Rules 2110 and 3040. The NASD found that the Gebharts had indeed violated these provisions and the SEC affirmed the NASD's findings. The Gebharts do not contest those findings in this appeal. Only the fraud charges are at issue here.

[6] NASD Conduct Rule 2120 provides: "No member shall effect any transaction in, or induce the purchase or sale of, any security by means of any manipulative, deceptive or other fraudulent device or contrivance."

Gebhart and imposed a one-year suspension and a $15,000 fine on Donna Gebhart. The SEC upheld the NASD decision in 2006.

The Gebharts petitioned for review of the SEC decision. We vacated and remanded in an unpublished decision, *Gebhart v. SEC,* 255 Fed. App'x 254, 2007 WL 4144635 (9th Cir. Nov. 21, 2007), out of concern that the Commission had applied a purely objective scienter standard that disregarded the Gebharts' actual state of mind. We remanded for reconsideration of the question of scienter and instructed the SEC to give careful consideration to the Gebharts' claims that, notwithstanding their objectively unreasonable conduct, they had acted in good faith.

On remand, the SEC once again determined that the Gebharts had acted with scienter and reaffirmed the NASD decision. The Gebharts have again petitioned for review. We have jurisdiction under 15 U.S.C. § 78y(a)(1), and deny the petition.

II. SCIENTER

The Gebharts challenge the SEC's finding of scienter on two bases. First, they contend that the SEC applied an erroneous legal standard for scienter. Second, they contend that the SEC's finding of scienter is not supported by substantial evidence. We reject their contentions.

A.

The first question is whether the SEC applied the correct scienter requirement applicable to a claimed violation of section 10(b) and Rule 10b-5. We review de novo the SEC's conclusions of law.[7]

Section 10(b) of the Securities Exchange Act of 1934 states, in relevant part:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . . [t]o use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j. SEC Rule 10b-5, which implements section 10(b), provides that it is unlawful "[t]o employ any device, scheme, or artifice to defraud." 17 C.F.R. § 240.10b-5(a). It also declares it unlawful "[t]o make

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[7] "The Commission's conclusions of law are to be set aside if arbitrary, capricious, or otherwise not in accordance with law." *Ponce v. SEC*, 345 F.3d 722, 728 (9th Cir. 2003) (quoting *Rutherford v. SEC*, 842 F.2d 214, 215 (9th Cir. 1988)) (internal quotation marks omitted).

any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading." *Id.* § 240.10b-5(b).

To establish a violation of section 10(b) and Rule 10b-5, the SEC is required to "show that there has been a misstatement or omission of material fact, made with scienter." *Ponce v. SEC*, 345 F.3d 722, 729 (9th Cir. 2003) (quoting *SEC v. Fehn*, 97 F.3d 1276, 1289 (9th Cir. 1996)) (internal quotation marks omitted); *see also SEC v. Rana Research, Inc.*, 8 F.3d 1358, 1364 (9th Cir. 1993) (discussing the elements the SEC must prove to establish a misrepresentation violating Rule 10b-5).[8] "The plaintiffs may establish scienter by proving either actual knowledge or recklessness." *In re Software Toolworks Inc.*, 50 F.3d 615, 626 (9th Cir.

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[8] The elements of a section 10(b) or Rule 10b-5 claim vary depending on the identities of the parties and the nature of the relief sought. In a *private* securities fraud action, the plaintiff generally must prove five elements: (1) a material misrepresentation or omission of fact; (2) scienter; (3) a connection with the purchase or sale of a security; (4) transaction and loss causation; and (5) economic loss. *Zucco Partners, LLC v. Digimarc Corp.*, 552 F.3d 981, 990 (9th Cir. 2009). Our focus here is on the elements that the SEC must establish. The fourth and fifth elements of a private claim are therefore inapplicable. In this case, moreover, only the scienter element is at issue. The Gebharts do not dispute that their statements were material or in connection with the sale of securities, and, for the reason given in Part III, they have not preserved their claim that their statements were not false.

1994); *see Ponce,* 345 F.3d at 729 ("[S]cienter may be established by demonstrating that the defendant acted recklessly." (citing *Hollinger v. Titan Capital Corp.,* 914 F.2d 1564, 1568-69 (9th Cir. 1990) (en banc))).

Scienter may be established, therefore, by showing that the defendants knew their statements were false, or by showing that defendants were reckless as to the truth or falsity of their statements. *See Ponce,* 345 F.3d at 729-30 (scienter is established where defendants make "statements that they know, or are reckless in not knowing, are false"); *In re Vantive Corp. Sec. Litig.,* 283 F.3d 1079, 1085 (9th Cir. 2002) (scienter is established where "the defendant made false or misleading statements either intentionally or with deliberate recklessness"), *abrogation on other grounds recognized by South Ferry LP, No. 2 v. Killinger,* 542 F.3d 776, 784 (9th Cir. 2008); *United States v. Farris,* 614 F.2d 634, 638 (9th Cir. 1979) ("[T]he reckless disregard for truth or falsity is sufficient to sustain a finding of securities fraud.").[9]

This familiar definition of scienter in a securities fraud case based on a misrepresentation is recognized

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[9] In some circumstances not relevant here, the Private Securities Litigation Reform Act (PSLRA) requires a showing that the defendants knew their statements were false. *See* 15 U.S.C. § 78u-5(c)(1)(B)(i) (requiring "actual knowledge . . . that the statement was false or misleading" in private securities actions challenging forward-looking statements). The claims in this case are not covered by the PSLRA, so scienter can be established by either knowledge or recklessness.

not only in this circuit but in others as well. In *SEC v. Lyttle*, 538 F.3d 601, 603 (7th Cir. 2008), for example, Judge Posner explained that to establish scienter the SEC was required to show that "the defendants either knew that the representations they made to investors were false or were reckless in disregarding a substantial risk that they were false." *See also South Cherry Street, LLC v. Hennessee Group LLC*, 573 F.3d 98, 109 (2d Cir. 2009) ("This Court has also long held that the scienter element can be satisfied by a strong showing of reckless disregard for the truth."); *Levinson v. Basic Inc.*, 786 F.2d 741, 749 (6th Cir. 1986) ("Scienter, a traditional element of a section 10(b) and Rule 10b-5 action, can be proven by a showing that the defendants issued false or misleading . . . statements with knowledge that those statements were false or misleading, or with reckless disregard as to their false or misleading character.") (citation omitted), *vacated on other grounds, Basic Inc. v. Levinson*, 485 U.S. 224 (1988). It is also consistent with traditional common law principles. *See generally* Restatement (Second) of Torts § 526 (1977) (permitting scienter to be established by showing either knowledge or conscious recklessness).[10]

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[10] The conclusion that we require either knowledge of falsity or conscious recklessness is supported by our decision in *In re Silicon Graphics Inc. Securities Litigation*, 183 F.3d 970 (9th Cir. 1999), *abrogation on other grounds recognized by South Ferry LP*, 542 F.3d at 784, where we explained that, in the securities fraud context, scienter requires "deliberate recklessness," which

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"Scienter can be established by direct or circumstantial evidence." *Provenz v. Miller*, 102 F.3d 1478, 1490 (9th Cir. 1996). In *Hollinger*, we explained that the objective unreasonableness of a defendant's conduct may give rise to an inference of scienter:

> [R]eckless conduct may be defined as . . . an extreme departure from the standards of ordinary care, . . . which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.

Hollinger, 914 F.2d at 1569 (quoting *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977)) (first alteration in original).

Scienter, however, is a subjective inquiry. It turns on the defendant's actual state of mind. *See* 8 Louis Loss & Joel Seligman, *Securities Regulation* 3676 (3d ed. 2004). Thus, although we may consider the objective unreasonableness of the defendant's conduct to raise an inference of scienter, the ultimate question is whether the defendant knew his or her statements were false, or was consciously reckless as to their truth or falsity. *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 206 (1976) ("There is no indication that Congress intended anyone to be made liable for such practices unless he acted other than in good faith."); *Hollinger*, 914 F.2d at 1570 (scienter requires

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we defined as conduct reflecting "some degree of intentional or conscious misconduct." *Id.* at 977.

"something more egregious than even 'white heart/ empty head' good faith." (quoting *Sundstrand,* 553 F.2d at 1045) (internal quotation marks omitted)); *Kaplan v. Rose,* 49 F.3d 1363, 1379-81 (9th Cir. 1994) (applying good faith standard); *In re Worlds of Wonder Sec. Litig.,* 35 F.3d 1407, 1425 (9th Cir. 1994) (same); *In re Apple Computer Sec. Litig.,* 886 F.2d 1109, 1117-18 (9th Cir. 1989) (same); *cf.* Restatement (Second) of Torts § 526 cmt. d ("The fact that the misrepresentation is one that a man of ordinary care and intelligence in the maker's situation would have recognized as false is not enough to impose liability . . . , *but* it is evidence from which his lack of honest belief may be inferred." (emphasis added)).[11]

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[11] Our decision in *Kaplan* is illustrative of the respective roles played by the objective and subjective components of the scienter inquiry. We began by citing *Hollinger* and observing that scienter can be established by showing an extreme departure from the ordinary standards of care and an obvious danger of misleading investors. 49 F.3d at 1378. But we also observed that several defendants had submitted sworn declarations testifying that they believed in good faith that their statements were true. *Id.* at 1379. The plaintiff argued that he had presented sufficient evidence of scienter to survive summary judgment because "[t]hese statements are so false that defendants must have known they were false and must have intended to mislead the public." *Id.* We disagreed, explaining that plaintiff's argument "does not suffice to rebut the declarations of good faith made by the defendants." *Id. Kaplan* shows that the objective unreasonableness of the defendant's actions may raise an inference of scienter, but the factfinder must consider the direct and circumstantial evidence as a whole to determine whether the defendant knew his or her statements were false, or consciously disregarded the risk that they were false. *See Kaplan,* 49 F.3d at

(Continued on following page)

B.

The Gebharts contend that the SEC applied an erroneous scienter standard in this case by focusing exclusively on *Hollinger*'s objective inquiry and disregarding evidence of subjective good faith. We disagree. The SEC considered all of the evidence bearing on the Gebharts' actual state of mind, including the Gebharts' extreme departure from ordinary standards of care, and found that the Gebharts were consciously aware of the risk that their statements were false. There was no error.

The SEC certainly considered the objective unreasonableness of the Gebharts' actions as *part* of its analysis. The SEC found that the Gebharts' failed to perform any meaningful investigation into the MHP promissory notes – an extreme departure from ordinary standards of care that "created the substantial [and obvious] risk . . . that their representations were not true." The SEC found that the Gebharts "made no effort to investigate or understand why their clients were being sold second (and not first) deeds of trust; no effort to identify the first trust deed holders or the amounts of those outstanding trust deeds; and no effort to ensure their clients' investments were actually being secured by recorded trust deeds." The Gebharts

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1379-80; *Worlds of Wonder*, 35 F.3d at 1424-25; *Apple*, 886 F.2d at 1117-18. In *Kaplan*, as to those particular defendants, the evidence as a whole was insufficient to survive summary judgment.

made "no effort" to corroborate Archer's representations that the parks were not overly encumbered.

The SEC properly considered the objective unreasonableness of the Gebharts' actions as some evidence supporting the inference that the Gebharts acted with scienter, but did not treat it as dispositive. The Commission recognized that scienter turns on "an actor's actual state of mind at the time of the relevant conduct." It considered the Gebharts' arguments that they acted in good faith and took into account "the Gebharts' assertions that they believed they had done enough to confirm the truthfulness of their statements to clients." It evaluated "the evidence the Gebharts put forward to demonstrate their good faith beliefs" as "part of the complete mix of facts bearing on an evaluation of their [actual] state of mind" and concluded that the "[e]vidence from the Gebharts about their subjective belief [wa]s not sufficient to overcome" the inference of scienter created by the evidence as a whole. The Gebharts' assertions of good faith were "not plausible" and lacked "credibility." Based on the evidence as a whole, the SEC determined that the Gebharts "knew they had no direct knowledge of the truth or falsity" of their statements, and made their statements "despite not knowing whether they were true or false." The SEC correctly applied the appropriate scienter standard.

C.

The Gebharts also argue that the SEC's finding that they acted with scienter is not supported by substantial evidence. We disagree.

The SEC's factual findings are reviewed for substantial evidence. *Ponce,* 345 F.3d at 728. The substantial evidence standard also applies to the SEC's finding of scienter. *Vernazza v. SEC,* 327 F.3d 851, 859 (9th Cir.), *amended by* 335 F.3d 1096 (9th Cir. 2003). Substantial evidence means more than a mere scintilla but less than a preponderance; it means such relevant evidence as a reasonable mind might accept as adequate to support a conclusion. *NLRB v. Int'l Bhd. of Elec. Workers, Local 48,* 345 F.3d 1049, 1053-54 (9th Cir. 2003). The standard is "extremely deferential" and a reviewing court must uphold the agency's findings "unless the evidence presented would *compel* a reasonable finder of fact to reach a contrary result." *Monjaraz-Munoz v. INS,* 327 F.3d 892, 895 (9th Cir.), *amended by* 339 F.3d 1012 (9th Cir. 2003) (quoting *Singh-Kaur v. INS,* 183 F.3d 1147, 1149-50 (9th Cir. 1999)) (internal quotation marks omitted). If the evidence is susceptible to more than one rational interpretation, we may not substitute our judgment for that of the agency. *Bear Lake Watch, Inc. v. Fed. Energy Regulatory Comm'n,* 324 F.3d 1071, 1076 (9th Cir. 2003).

The Gebharts point out that there is *some* evidence supporting an inference that they genuinely believed that they had an adequate basis for their

statements. Significantly, the Gebharts themselves invested substantially in the MHP notes. *See* 8 Loss & Seligman, *supra,* at 3691 n.558 ("[I]nvestment of one's own money tends to negate scienter, since it 'belies any known or obvious danger.'" (quoting *Hoffman v. Estabrook & Co.,* 587 F.2d 509, 517 (1st Cir. 1978))). The Gebharts also may have sincerely, if mistakenly, believed that MONY and MSC had approved the MHP program.

Substantial evidence, however, supports the SEC's finding of recklessness. The Gebharts represented that the MHP notes were a good investment, that they were secured by recorded trust deeds and that in the event of a problem investors would be able to get their investments back because the parks were not heavily leveraged. The Gebharts based these statements on representations by Archer and conducted no meaningful independent investigation to confirm the truth of their representations.[12] It was therefore

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[12] The Gebharts contend that they conducted an adequate investigation into the MHP program and that they sincerely believed they had a reasonable basis for their statements that the MHP notes were secured and that the parks were not overencumbered. In addition to their own purchases of MHP notes, they point to (1) their mistaken belief (based on Archer's statements) that MONY had approved the MHP program; (2) their having informed MSC's compliance officer about the MHP program and receiving no objection in response; (3) their belief that third party banks would confirm that deeds of trust were being recorded; (4) the absence of any problems with payments on the notes prior to 2000; (5) their visits to two mobile home parks that were part of the program; and (6) statements by clients that

(Continued on following page)

reasonable for the SEC to infer that the Gebharts were consciously aware that they lacked sufficient information for their statements. *See* Restatement (Second) of Torts § 526 (1977) ("A misrepresentation is fraudulent if the maker . . . does not have the confidence in the accuracy of his representation that he states or implies, or . . . knows that he does not have the basis for his representation that he states or implies."). By asking the court to draw inferences different from those reasonably drawn by the SEC, the Gebharts misapprehend the nature of our review. *See Vernazza*, 327 F.3d at 861. We may not substitute our judgment for the reasonable judgment of the Commission. *See Ponce*, 345 F.3d at 728 ("If . . . the evidence is open to

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the Gebharts never intended to deceive them. They also rely on the NASD hearing panel's finding that they "truly believed that they had fulfilled their responsibilities to assure that MHP and CSG were appropriate investments." The SEC reasonably discounted most of this evidence. The Gebharts failed to confirm Archer's claim that MONY had approved the MHP program and the Gebharts acknowledge that MSC never formally approved the program. Whether clients believed the Gebharts intended to deceive them – there is no evidence in the record that the Gebharts ever intended to defraud anyone – is irrelevant to whether the Gebharts made statements *recklessly*. The Gebharts' visits to the two parks afforded them no information about whether the parks were overencumbered or the trust deeds were recorded. The SEC found no credibility in the Gebharts' claims that they relied on third-party banks to ensure the validity of the MHP program and the recording of trust deeds. The hearing panel's finding of good faith was reversed by the NASD National Adjudicatory Council. Our role is not to weigh the evidence for ourselves but to determine whether the SEC reached *a* reasonable conclusion. We cannot say that it did not do so.

more than one interpretation, we are required to uphold the SEC's finding.").

III. Remaining Issues

The Gebharts' remaining contentions are unpersuasive. The SEC adequately explained its determination not to defer to the NASD hearing panel's finding that the Gebharts acted in good faith by offering detailed, specific reasons supported by substantial evidence for rejecting the hearing panel's finding. *See Maka v. INS*, 904 F.2d 1351, 1355 (9th Cir. 1990), *amended by* 932 F.2d 1352 (9th Cir. 1991). The Gebharts waived their challenges to the SEC's factual findings (that the trust deeds were not recorded and that the parks were overencumbered) by failing to raise them in their prior appeal. *See In re Cellular 101, Inc.*, 539 F.3d 1150, 1155-56 (9th Cir. 2008). The SEC did not abuse its discretion by imposing a lifetime bar on Alvin Gebhart. *See Ponce*, 345 F.3d at 740-41.

PETITION DENIED.

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 58951/November 14, 2008

Admin. Proc. File No. 3-11953r

In the Matter of the Application of

ALVIN W. GEBHART, JR.
and
DONNA T. GEBHART

c/o Charles F. Goria
Goria, Weber & Jarvis
1011 Camino Del Rio South, Suite 210
San Diego, CA 92108

For Review of Disciplinary Action Taken by NASD

OPINION OF THE COMMISSION

REGISTERED SECURITIES ASSOCIATION – REVIEW OF DISCIPLINARY PROCEEDING

Redetermination of Liability on Remand for Fraudulent Sale of Securities

The Ninth Circuit Court of Appeals affirmed the Commission's finding that registered representatives of member firm of registered securities association engaged in private securities transactions without giving prior written notification to, or obtaining prior approval from, member. The Court remanded for further findings on whether representatives violated antifraud provisions

with the requisite scienter when they made material misrepresentations and omissions in the sale of securities. *Held,* representatives recklessly made material misrepresentations and omissions, and association's findings of liability and the sanctions imposed therefor are *sustained.*

APPEARANCES:

Charles F. Goria, of Goria, Weber & Jarvis, for Alvin W. Gebhart, Jr. and Donna T. Gebhart.

Marc Menchel, James S. Wrona, and Michael J. Garawski, for Financial Industry Regulatory Authority, Inc., Department of Enforcement, for NASD.

Case remanded: January 15, 2008
Last brief received: June 13, 2008

I.

This proceeding is before us on remand from the United States Court of Appeals for the Ninth Circuit (the "Court"). On January 18, 2006, we issued an opinion and order (the "2006 Opinion") sustaining NASD disciplinary action against Alvin W. Gebhart, Jr., and Donna T. Gebhart, registered representatives formerly associated with Mutual Service Corporation, an NASD member firm.[1] NASD found that the

[1] *Alvin W. Gebhart, Jr., and Donna T. Gebhart,* Securities Exchange Act Rel. No. 53,136 (Jan. 18, 2006), 87 SEC Docket 437, *remanded, Gebhart v. SEC,* 255 Fed. Appx. 254 (9th Cir. Nov. 21, 2007).

(Continued on following page)

Gebharts, in offering and selling over $2 million in unregistered promissory notes from 1997 through early 2000, violated the registration and antifraud provisions of the federal securities laws as well as several NASD rules. NASD found that, because the promissory notes were securities, no registration statement was in effect as to the notes, and no exemption applied, the Gebharts' sales violated Section 5 of the Securities Act of 1933[2] and NASD Conduct Rule 2110.[3] NASD found further that the Gebharts had not obtained prior written permission from their firm to engage in the sale of the notes, thereby violating NASD Conduct Rules 3040 and 2110.[4] NASD also found that the Gebharts violated several antifraud provisions: Section 10(b) of the Securities Exchange Act of 1934, Exchange Act Rule 10b-5, and

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On July 26, 2007, the Commission approved a proposed rule change filed by NASD to amend NASD's Certificate of Incorporation to reflect its name change to Financial Industry Regulatory Authority Inc., or FINRA, in connection with the consolidation of the member-firm regulatory functions of NASD and NYSE Regulation, Inc. See Exchange Act Rel. No. 56,146 (July 26, 2007), 72 Fed. Reg. 42,190 (Aug. 1, 2007). Because the disciplinary action here was taken before that date, we continue to use the designation NASD in this opinion.

[2] 15 U.S.C. § 77e.

[3] NASD Conduct Rule 2110 requires adherence to just and equitable principles of trade.

[4] NASD Conduct Rule 3040, titled "Private Securities Transactions of Associated Persons," prohibits involvement by associated persons of member firms in a transaction outside the regular course or scope of employment without providing prior written notice to the member firm.

NASD Conduct Rule 2120, in connection with their offer and sale of the notes.[5]

For selling unregistered securities and engaging in securities transactions without permission from their firm, NASD barred Alvin Gebhart and suspended Donna Gebhart for one year and fined her $5,000. For their violations of the antifraud provisions, Alvin Gebhart received another bar, and Donna Gebhart received a second one-year suspension (to be served concurrently with her first suspension) and a $10,000 fine. We sustained both NASD's findings of violation and the sanctions imposed.

Following issuance of the 2006 Opinion, the Gebharts appealed those portions of the decision that found the Gebharts liable for selling securities without their firm's permission and for engaging in fraud.[6] On November 21, 2007, the Court of Appeals affirmed the findings of liability with respect to the Gebharts' selling of securities without firm permission.[7] However, the Court reversed the findings that the Gebharts had engaged in fraud, vacated the sanctions based thereon, and remanded the matter "for

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[5] 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5. NASD Conduct Rule 2120 prohibits fraud in the offer and sale of securities.

[6] The Gebharts did not contest, in their appeal to the Court, the finding that the promissory notes in question were securities and that the Gebharts violated Securities Act Section 5 and NASD Rule 2110 by offering and selling the unregistered notes. Those findings are therefore final.

[7] *Gebhart v. SEC*, 255 Fed. Appx. at 256.

further findings on the factually intensive question of whether the Gebharts acted with the requisite scienter" to support the findings of fraud.[8] In this opinion we address the Court's concerns, focusing on whether the Gebharts acted recklessly when they offered and sold the securities at issue in this case.[9] We find that the Gebharts' conduct did, in fact, satisfy the Court's definition of recklessness, for the reasons explained below.

II.

For purposes of this opinion, the pertinent facts are as follows. The Gebharts were securities

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[8] *Id.*

[9] In reaching our decision, we have considered the arguments of the parties in briefs submitted pursuant to a scheduling order issued on February 6, 2008 as well as an order issued May 29, 2008 granting a request by the Gebharts to submit supplemental briefing on the relevance of a recent decision of the United States District Court for the Southern District of California, *SEC v. Platforms Wireless Int'l Corp.*, 559 F.Supp.2d 1091, 1096-97 (S.D. Cal. 2008) (defining recklessness in the context of fraud as "'a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it'" and noting that "'recklessness only satisfies scienter under § 10(b) to the extent that it reflects some degree of intentional or conscious misconduct'" (quoting *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1569 (9th Cir. 1990) and *In re Silicon Graphics, Inc. Sec. Litig.*, 183 F.3d 970, 977 (9th Cir. 1999))).

salespersons with Mutual Service Corporation ("MSC"), a broker-dealer and member of NASD. From 1997 to 2000, the Gebharts offered and sold to their clients nearly $2.4 million in unregistered promissory notes ("Notes") issued by MHP Conversions, LLC ("MHP"). MHP sold the Notes purportedly to finance the conversion of mobile home parks to resident ownership. MHP's sales literature represented that a related company, Community Service Group ("CSG"), would purchase the parks from the owner and then assist the park's residents with legal and financial arrangements so that they could ultimately purchase the property themselves.

Gebhart, who has been in the securities industry since 1983, learned about the Notes in late 1995, while working at Mutual of New York ("MONY"), from another MONY salesman named Jack Archer. Gebhart thought highly of Archer, an ex-Marine and Vietnam veteran with more experience selling securities than Gebhart. Archer had a short discussion with Gebhart in which Archer briefly described the MHP trailer park program and asked if Gebhart would be interested in it. Gebhart referred three of his clients to Archer; all three invested funds with Archer, who paid Gebhart a finder's fee.[10] According to the Gebharts, the fact that these clients did not

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[10] Neither NASD nor we based any findings of liability on these three referrals.

complain about their investments later served as a basis for their recommendation of the Notes to others.

The Gebharts understood that MHP was created to issue the Notes that were sold to individual investors to raise the funds necessary for CSG's purchase of the parks. However, the record is unclear as to these entities' actual roles in any transactions related to the ownership interests in the parks, and the Gebharts' own understanding of the mechanics of these transactions was vague. For example, asked why the Notes were issued by MHP, Gebhart testified, "Because of the fact that the parks – when they were trying to do a park [Archer] would tell us, 'I have this park that's going through a conversion.' We would get the name of the park to be done and get the check made out to that name and then it wouldn't work for some apparent reason and the check would be given back to the client. This is an easier way of facilitating the process, is what he explained to me." The Gebharts made no effort to understand or investigate why their clients were being sold second (and not first) deeds of trust, nor did they know or inquire about the identities of the first trust deed holders or the amounts of those outstanding first trust deeds. When asked to explain the process MHP used to issue and secure trust deeds on trailer parks it was converting, Donna Gebhart was unable to describe it, testifying, "I wish I could explain it more. I wish I would have known more."

The MHP Notes had one-year terms with fixed interest rates of 18% for new investments and 14% on

reinvested funds. Each Note stated that it would "ultimately be secured by a deed of trust" on the particular park to be purchased with the funds, but that "[u]ntil such time as said deed of trust is recorded, the sole asset of [the issuer] will be a deed of trust for the property known as Eastern Trailer Park . . . in the amount of $100,000."

In late January 1996, Gebhart left MONY to join MSC; his wife soon thereafter became a registered representative and joined him in selling insurance and mutual funds and providing financial planning services in their California branch office. On October 2, 1996, at Archer's suggestion, the Gebharts themselves invested $7,000 in the Notes.[11] On October 23, 1996, Archer asked the Gebharts if they were interested in selling Notes directly to their clients. The Gebharts had a lengthy discussion with him about the Note program. Archer represented that he had done his own due diligence and had received permission from his own firm to sell the Notes. In fact, Archer did not receive permission from his firm to sell the Notes.[12] Archer also told the Gebharts that "all of the governmental agencies were involved," "the parks

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[11] The Gebharts eventually purchased nearly $70,000 in Notes, though some portion of this amount represents reinvestment of funds from matured Notes. As noted infra, the Gebharts had about half this amount invested in Notes when MHP eventually collapsed in the spring of 2000.

[12] Archer was a named respondent in the proceedings before NASD, but he defaulted and was barred by NASD from associating with any member firm.

were in good shape," "had a lot of equity in them," and were only "45 to 55 percent leveraged." The Gebharts had also received from Archer a packet of marketing materials prepared by the issuer.[13]

The Gebharts discussed the MHP Note program with their firm, MSC, in a single phone call soon after their conversation with Archer. Alvin Gebhart testified that, during this call, he had a relatively lengthy conversation with the compliance director at MSC, during which Gebhart explained the program in detail, disclosed that he would be receiving commissions on the sales, and answered "a lot" of questions. The MSC compliance officer testified that the call was "a casual five-minute conversation" in which Gebhart told him "very little" about the Notes. However, the parties agree that MSC did not give permission to the Gebharts to sell the Notes during that telephone call. The Gebharts forwarded a copy of the MHP marketing materials by courier to MSC but never received a response. Nevertheless, the Gebharts

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[13] This included a sample promissory note, a "brochure" that featured a printout from CSG's Web site describing its park-conversion business, several local newspaper articles that reported successful park conversions, several one-page descriptions of converted parks, and "pro forma" financial information for one park conversion that provided a brief projected cash flow analysis and an investment summary that sketched the outlines of CSG's plan to borrow funds to convert the park. MHP was mentioned in these materials only in that the company's name appeared on the cover of the brochure along with CSG's.

began offering and selling MHP Notes to their clients a few months later, in early 1997.

In addition to having contacted MSC for permission to sell the Notes (permission they never received), the Gebharts made available to MSC auditors in November 1997 and February 1999 their transaction logs and client files that contained some evidence of MHP Note purchases. The auditors did not raise any objections to the Note program. Although the Gebharts appear to have made no attempt to hide from the MSC auditors information about the MHP Notes, it is unclear whether the auditors actually saw any of the evidence of the purchases.

The Gebharts' administrative assistant also contacted MSC's operations department in September 1998 to inquire whether funds held in a retirement account could be used to purchase an MHP Note, and MSC's operations department faxed its approval of the MHP Notes for holding in a 403(b) account. The Gebharts' office assistant testified in a deposition in a related civil case that this communication with MSC about the Notes was limited solely to finding out what administrative steps the client needed to take to hold an MHP Note in her 403(b) account. Ultimately, two Note purchases were made with 403(b) funds, and the paperwork for these purchases cleared MSC's operations department without comment. It is undisputed, however, that MSC's compliance department, which was responsible for approving outside business activities, did not review these transactions.

Nevertheless, Gebhart testified that he had done "the proper due diligence" by talking to Archer, contacting MSC, and visiting two of the trailer parks to be converted. Other than these two site visits, the value of which was questionable,[14] the Gebharts made no attempt to gather information on the individual parks in which their clients would be investing through MHP.

The Gebharts concluded that the Note program was a successful venture because they "didn't hear any complaints" from early investors. The Gebharts neither sought nor possessed any information about the management or financial health of MHP, apparently considering it irrelevant: Gebhart testified that he never imparted any information about MHP to clients because his clients "were, as I saw, lending money to a mobile home park itself." According to Donna Gebhart, "[i]t was always our understanding that [MHP] wouldn't have done a conversion on a

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[14] Gebhart testified in a civil deposition in a related case that these site visits consisted of the following:

> What we did is I went up to the Flinn Springs trailer park, drove in, looked around to see the quality of it, to see if it's there, if it's a bona fide piece of real estate, there were mobile homes on it, people living in those mobile homes, whether it was upkept – kept up. Same thing in Aviation. I drove in, looked around, see if there's people living there, if mobile homes were there. In fact, they were.

In this connection, we note that the Gebharts' clients eventually invested in several other parks in addition to the two that Gebhart visited.

park that wasn't – that didn't have good cash flow and that would be a deal worth them doing." Donna Gebhart did not explain what parameters she believed MHP used to determine if a deal was "worth doing," but testified that she simply "had faith with everybody that was involved that it was a good program."

In selling the Notes to their clients, the Gebharts presented the MHP program as an option for investors who needed a substantial, fixed monthly income. For example, investor Maribeth Trogdon, a recent widow with two dependent children whose only income was from a part-time teaching job, testified about her discussions with the Gebharts in a deposition in a civil case brought against Gebhart and MSC by clients who bought MHP Notes.[15] Trogdon testified that the Gebharts recommended that she invest a large portion (more than a third) of the life insurance proceeds from her husband's death into

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[15] NASD declined to base findings on depositions from Trogdon and other customers given in related civil proceedings brought by Note purchasers against Archer, the Gebharts, and their firms (the "Noteholder suit"). However, we see no reason not to consider this evidence. The Gebharts' lawyer was present during these depositions, and never objected to their inclusion in the record below (nor have the Gebharts objected subsequently). Moreover, the testimony appears credible in that the customers make similar assertions about what they were told by the Gebharts. *See Frank J. Custable, Jr.*, 51 S.E.C. 643, 648 (1993) (finding that "similarities in each customer's [challenged] testimony regarding [the salesperson's] behavior and treatment of them" strengthened finding of credibility).

MHP Notes to replace her husband's income. Notes that Trogdon made in preparation for the deposition state that "[t]he investment was presented to me as a proven, long term way for me to receive a substantial monthly income."[16] Trogdon also testified during the deposition that, when she asked the Gebharts how she could be sure the money she was putting toward the MHP Note "isn't being sent to Tahiti," the Gebharts replied that MSC "looks at all our business . . . and would tell them if there was anything incorrect by law."[17]

Investors testified that the Gebharts told them that the Gebharts had invested their own money in the Notes and that the program had so far been successful. Investor Donald Townsend, a retiree looking to supplement his retirement income "to take care of the bills," testified that Gebhart represented that MHP was "basically solvent and steadily growing[,] obtaining more parks[,] and had been paying the monthly interest with no problems." At the hearing, Gebhart confirmed that he believed the trailer park

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[16] Trogdon invested $160,000 in an MHP Note in March 1999. Trogdon, and all other investors whose testimony is cited in this opinion, represented in a signed proof of claim submitted to the district court handling MHP's bankruptcy that MHP failed to record a trust deed securing their promissory notes, and there is no evidence in the record that refutes the investors' claims.

[17] The Gebharts corresponded with their customers using letterhead that stated "Securities offered by Mutual Service Corporation."

program was a successful venture because he "didn't hear any complaints" from the three clients he had referred to Archer in early 1996.

Investors also testified that the Gebharts informed them that the MHP Notes would be secured by recorded deeds of trust, and that the parks would serve as sufficient collateral to secure all investments in the event of default. For example, Townsend testified, "I was told that [MHP] would purchase the mobile home parks with the money that's being loaned to them and that they would eventually secure the property with trust deeds. . . ."[18] Investor Larry Tickel, a disabled former Wal-Mart store manager, testified that the Gebharts assured him that "there was no risk because [the Note] was secured by a deed of trust and then that [the parks] would not be overbought. So that way, if they had to sell the place, we would still get our money back." Following up, the NASD attorney asked Tickel, "Is that what Mr. Gebhart told you, that there was no risk?" Tickel responded, "Right."[19]

Similarly, Sylvia Kerr, a disabled former court reporter who made a total of four investments in MHP Notes, testified in a deposition in the Noteholder suit that she "didn't want to have any risk"

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[18] Townsend invested $40,000 in an MHP Note in June 1998; he re-invested those funds in another Note and added another $2,200 to his investment in June 1999.

[19] Tickel invested $20,000 in an MHP Note in August 1999.

with the money she wanted to invest, and she "remembered us laughing and them [i.e., the Gebharts] saying, 'Well, if you don't want to take any risk, this would be the place to put your money again.' "[20]

The Gebharts' recollection of their representations to their clients is consistent with the clients' testimony. Gebhart testified that he told clients, "If they invested into [an MHP Note] they would get a recorded deed of trust. If the worst case scenario came down they would be part owners of that park." Donna Gebhart similarly testified, "If [clients] asked us about it, either [Gebhart] or I would say the type of thing it is; they are mobile home park conversions. We would give them the knowledge we had about them and we would tell them that they would own a piece of the park. . . . [I]f it was like worst case scenario, if something happened and the park were to default, we all would own a portion and we could be able to sell the park and we would all get cashed out."

However, MHP did not provide copies of the deeds of trust supposedly securing the Notes unless an investor requested one, and very few investors made such a request. The Gebharts recalled seeing one client's trust deed, but did not recall seeing any recording information. The Gebharts never asked for,

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[20] Kerr invested $10,000 in an MHP Note in January 1998; she re-invested those funds in new Notes in February 1999 and February 2000. In September 1999 Kerr made an additional Note purchase in the amount of $11,000.

nor received, a copy of the deeds of trust purportedly securing their own Notes. Indeed, the Gebharts point to only one trust deed contained in the record before us that was recorded; however, that recordation occurred in 1995, well before the Gebharts began selling Notes to their clients. Aside from the ambiguity of the recording status of the deeds purportedly securing their clients' Note purchases, the Gebharts did not have any information about the value of the properties that were intended to serve as collateral and did not know how many of these deeds of trust were supposedly filed against each property or the extent to which the properties were otherwise encumbered.

The Gebharts had essentially no contact with the issuer. Archer handled all the paperwork for the Gebharts' clients who bought MHP Notes and told the Gebharts not to contact MHP or CSG directly. Gebhart testified that he spoke to the principal of MHP once about an "administrative matter," but on the few other occasions the Gebharts tried to contact the company, the staff "kept referring [the Gebharts] back to Archer." Archer shared his commissions with the Gebharts, paying them checks drawn on his personal bank account.[21] They were paid 6-7% for new purchases and 3-4% for reinvested funds. By early 2000, the Gebharts had sold over $2.4 million in MHP

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[21] Archer testified in a deposition in the Noteholder suit that the commissions he earned on MHP Note sales represented more than half of his income in 1998 and 1999.

Notes to more than forty clients, for which they received over $110,000 in commissions.

In April 2000, MHP stopped making interest payments on the Notes. By this time, clients of the Gebharts had over $1.5 million invested in the securities; the Gebharts themselves had about $36,000 invested. On May 3, 2000, MHP sent a letter to Noteholders explaining that an illness of the company's owner was causing "cash flow problems." MHP claimed that approximately $605,000 worth of Notes had been secured by recorded deeds of trust but revealed that MHP owed nearly $3.7 million to holders of its promissory notes.[22]

The Gebharts reported in a May 2000 letter to their firm describing the collapse of the MHP Note program that "all of the mobile home parks appear[ed] to be substantially overencumbered," and that they had "no way of knowing this until May 11th of this year, when Mr. Archer showed us his note obligations." By their own admission, the Gebharts had been unaware that, by May 2000, Archer's clients had invested over $2 million in the same parks in which the Gebharts' own clients had invested over $1.5 million. By October 2000, the Gebharts had learned that MHP and related entities owned only

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[22] It is unclear whether MHP's representation that $605,000 worth of Notes had been secured by recorded deeds of trust is accurate. Even if true, however, the Gebharts point to no evidence, and we have found none, that any of their own clients' trust deeds were recorded.

"$500,000 – $700,000 in net assets" plus an insurance policy on the life of MHP's owner in the amount of $1 million. After the Gebharts notified MSC of MHP's collapse, MSC investigated the matter and, on August 11, 2000, terminated the Gebharts' association with the firm.

Following MHP's collapse, the Gebharts took steps to recover the money that they and their clients had invested, including filing a petition for involuntary bankruptcy against MHP. Purchasers of MHP Notes sued Archer, Gebhart, MONY, and MSC. When the Gebharts' liability insurer refused to indemnify Gebhart, the Gebharts sued the insurer to force it to pay for Gebhart's defense and any damages awarded to the Noteholders. The Gebharts' clients ultimately recovered approximately 84% of their investments.

III.

Exchange Act Section 10(b), Exchange Act Rule 10b-5, and NASD Rule 2120 prohibit fraudulent and deceptive acts and practices in connection with the offer, purchase, or sale of a security. Violations of these provisions may be established by a showing that persons acting with scienter misrepresented material facts or "engage[d] in deceit" in connection with securities transactions.[23]

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[23] *Basic Inc. v. Levinson,* 485 U.S. 224, 239 n.17 (1988); *Ernst & Ernst v. Hochfelder,* 425 U.S. 185, 193 n.12 (1976); Rule 10b-5(c), 17 CFR § 240.10b-5.

The 2006 Opinion found that the Gebharts made misrepresentations and omitted to state facts necessary to make other statements not misleading in connection with their offer and sale of over $2.4 million in MHP Notes to their customers. The Gebharts testified that they told customers that investments in the Notes would be secured – and therefore risk-free – because second deeds of trust on the properties purchased with client funds would be recorded, and because, in the event of a default on the MHP Notes, clients could recover their investments by foreclosing on the properties and liquidating the collateral. These statements were false: second deeds of trust purportedly securing the MHP Notes purchased by the Gebharts' clients in 1999 and 2000 were not recorded and, even had they been recorded, the properties would have been substantially overencumbered.[24]

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[24] The Gebharts argue that there is insufficient evidence to determine whether any of the deeds of trust of customers who were purportedly defrauded were properly recorded. Thus, they assert that there is no basis for finding that the Gebharts misrepresented that status to customers.

We disagree. The Gebharts admitted more than once during the hearing that they generally told clients who purchased MHP Notes that their investments would be secured by recorded deeds of trust, as discussed *infra*. Moreover, NASD specifically asked Gebhart whether he told all the clients named on a stipulated list of all forty-five Gebhart clients who purchased Notes "that the trailer parks were secured by a recorded deed of trust." Gebhart replied, "As best I recall, yes." Although the record does not show whether deeds securing Notes purchased before 1999 were recorded, all of the forty-five Gebhart clients who purchased Notes in 1999 and 2000 represented in court

(Continued on following page)

The Gebharts also failed to tell their clients throughout the relevant period that their recommendation of the Notes as a sound investment was not based on a thorough investigation but on statements made in MHP's marketing materials, representations by Archer, site visits the Gebharts made to two parks that confirmed nothing but that these particular parks existed, the absence of complaints from other customers, and the silence of MSC and other entities. We found that these misrepresentations and misleading omissions were material,[25] and the Court of Appeals did not disturb that finding.

We turn now to the question of whether the Gebharts acted with scienter in misleading their clients. As the Court of Appeals stated, "[s]cienter may be established by a showing that the [respondent] acted recklessly." Citing the definition of recklessness articulated in *Sundstrand Corp. v. Sun Chem. Corp.*, the Court explained that "[r]ecklessness in this context is 'a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards

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filings in MHP's bankruptcy that MHP failed to record a trust deed securing their promissory notes. The Gebharts introduced no evidence, and we are aware of no evidence, that contradicts those client representations.

[25] A fact is material if there is a substantial likelihood that a reasonable investor would have considered the fact important in making an investment decision, and disclosure of the omitted fact would have significantly altered the total mix of information available. *Basic*, 485 U.S. at 231-32.

of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.'"[26] The Court then described objective and subjective components of recklessness. The objective component asks what a reasonably prudent securities professional under the circumstances would have done, while the subjective component looks at an actor's actual state of mind at the time of the relevant conduct. As examples of situations in which a defendant would escape liability under the subjective component, the court in *Sundstrand* identified cases in which "a defendant genuinely forgot to disclose information" or where the omitted information "never came to his mind."[27] The Court also asked us to address the situation in which a respondent seeks to establish a good faith defense to scienter.

After further review of the record in light of the Court's remand opinion, we remain convinced that the Gebharts' conduct satisfies this definition of recklessness. The Gebharts made critical representations

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[26] *Gebhart v. SEC*, 255 Fed. Appx. at 255 (quoting *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1569 (9th Cir. 1990) (quoting *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977))). The Seventh Circuit recently observed with respect to the *Sundstrand* recklessness standard: "When the facts known to a person place him on notice of a risk, he cannot ignore the facts and plead ignorance of the risk." *Makor Issues & Rights, Ltd. v. Tellabs Inc.*, 513 F.3d 702, 704 (7th Cir. 2008).

[27] *Sundstrand*, 553 F.2d at 1045 n.20.

– those related to the safety of the Notes as an investment – without having performed any meaningful investigation into the actual securitization of the Notes. This created the substantial risk – which would have been obvious to any reasonable person and which must have been obvious to the Gebharts – that their representations were not true. Evidence from the Gebharts about their subjective belief is not sufficient to overcome these conclusions.

The Gebharts admit that they told clients who invested in MHP Notes that they "would get a recorded deed of trust" and that the "worst case scenario" was that the investors could sell the park and all investors would "get cashed out." Yet the Gebharts knew they had no direct knowledge of the truth or falsity of these statements. The Gebharts testified that they remembered seeing only one client's trust deed but did not recall any recording information for that single deed. They never even saw, or requested to see, the trust deeds purportedly securing their own Note purchases. The Gebharts made no effort to investigate or understand why their clients were being sold second (and not first) deeds of trust; no effort to identify the first trust deed holders or the amounts of those outstanding first trust deeds; and no effort to ensure their clients' investments were actually being secured by recorded trust deeds.

Nor did the Gebharts have any direct knowledge about the value of collateral supposedly securing the Notes. Although Archer claimed that no park would have more than ten investors and that the parks

would be only 45-55% leveraged, aside from Archer's assertion, the Gebharts had no way of knowing if those statements were true because the Gebharts admit they made no effort to confirm them. Indeed, the Gebharts testified that they did not keep track of the number or amount of investments their own clients made in each park and did not know or ask how many of Archer's clients were investing in those same parks; nor did they know how many investors, referred perhaps by other representatives or other intermediaries like Archer, might also have been purchasing Notes.[28] The Gebharts admitted they never sought or examined any information or documents that normally help to estimate the value of real property, such as an appraisal, prior sale history, title report, or the like. They simply made no effort to confirm that the parks had sufficient assets to pay for the return of their clients' investments after any necessary payments to other lienholders.

Instead of making any effort to confirm the truth of their statements to clients, the Gebharts claim to have substituted reliance on the vague and conclusory statements made in the issuer's marketing materials, the uncorroborated representations of Archer, site visits the Gebharts made to two parks, the silence – interpreted without question, confirmation,

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[28] Although the record indicates that Archer and the Gebharts were the only representatives selling MHP Notes, the Gebharts do not appear to have been aware of this fact at the time they were selling the Notes.

or follow-up by the Gebharts as comprehensive approval – of MONY, MSC, and other entities, and the absence of complaints from the customers to whom they had already sold Notes.[29] As Donna Gebhart put it, they simply "had faith with everybody that was involved that it was a good program."

The Gebharts' misplaced "faith" does not overcome our finding of recklessness given the obvious warning signs that some investigation was necessary.

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[29] The Gebharts claim that they relied in part on due diligence they believed was being performed by First Regional Bank, where certain of their customers maintained custodial accounts. They argue that the bank represented, in its investment authorization form, that when a customer wished to purchase a deed of trust with custodial funds, the bank was required to review escrow instructions, which "would reflect . . . the trust deed to be recorded." The fact that the bank would review trust deeds securing Notes purchased with custodial funds supposedly gave comfort to the Gebharts that their clients' investments were secured.

However, the bank's form notes only that, as part of its review for "administrative feasability," the bank expected to review the "proposed" promissory note before disbursing funds. The form states that the investor must forward to the bank "original documents" such as a "recorded mortgage/deed of trust," and specifically disavows responsibility "for obtaining these documents or verifying the position of the investment, e.g., first or second mortgage/deed of trust." The record does not demonstrate that the Gebharts had any relationship with the bank that would have permitted them to conclude that the bank's internal review processes precluded any need for their own due diligence. Moreover, if the Gebharts considered it to be MHP's responsibility to eventually provide recorded deeds of trust to the bank, they made no effort to ensure MHP (or anyone else) was doing so.

For example, the Gebharts were effectively precluded from having any direct contact with MIIP, which was purportedly responsible for securing the Notes, and were paid their commissions by Archer, through his own personal account, not by MHP.[30] Moreover, the Notes explicitly stated that each Note would be collateralized by only a single (never-changing) asset purportedly worth $100,000 until the Notes would be "eventually" secured by recorded deeds of trust, with the result that when a particular park attracted more than $100,000 worth of Note purchases, those investments would be insufficiently collateralized, by the very terms of the Note program, unless and until second trust deeds securing the Notes were recorded. Further, the Gebharts' investors, as second trust deed holders, were by definition subordinate to holders of first trusts should the parks' creditors need to foreclose, making it even more critical that the Gebharts confirm their clients' chances of recovering their investments.[31] Yet the Gebharts ignored these facts, performed no investigation, and asserted the truth of

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[30] *See Jay Houston Meadows*, 52 S.E.C. 778, 785 (1996) (finding that salesman of a registered broker-dealer made misrepresentations that were reckless, based in part on a denial of unrestricted access to the issuer's records even though salesman claimed "not to have been troubled by this development"), *aff'd*, 119 F.3d 1219 (5th Cir. 1997).

[31] It is also unclear whether there may have been other second trust holders who, by virtue of having recorded their interests first in time, would have priority over MHP Note purchasers. There is no evidence that the Gebharts considered or investigated this possibility.

critical matters with no objective, independent basis for doing so. This constitutes reckless conduct, and the Gebharts are legally bound as knowing of the risk of misleading their clients.[32]

The Gebharts nevertheless argue that they should not be found liable for fraud because they acted in good faith, and therefore without the requisite state of mind. They contend that, as found by the NASD Hearing Panel, the Gebharts "truly believed that they had fulfilled their responsibilities to assure that MHP and CSG were appropriate investments. . . ."

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[32] As explained by the *Sundstrand* court:

> Under this definition [of recklessness], the danger of misleading buyers must be actually known or so obvious that any reasonable man would be legally bound as knowing, and the omission must derive from something more egregious than even "white heart/empty head" good faith. While this definition might not be the conceptual equivalent of intent as a matter of general philosophy, it does serve as a proper legally functional equivalent for intent, because it measures conduct against an external standard which, under the circumstances of a given case, results in the conclusion that the reckless man should bear the risk of his omission. When measured against this external standard, it may be said that such a reckless man "has use[d] or employ[ed a] deceptive device" within Section 10(b).

553 F.2d at 1045 (citations omitted). *See also McLean v. Alexander*, 599 F.2d 1120, 1198 (3d Cir. 1979) ("[F]raud 'includes the pretense of knowledge when knowledge there is none.'") (citing *Ultramares Corp. v. Touche, Niven & Co.*, 255 N.Y. 170, 179 (Ct. App. N.Y. 1931)); OLIVER WENDELL HOLMES, JR., THE COMMON LAW 135-36 (1881).

The Hearing Panel decision on this point was overturned by NASD's National Adjudicatory Council ("NAC"), which found that the Gebharts were reckless and concluded that the four factors identified by the Hearing Panel provided "scant reasons for the Gebharts to believe they had fulfilled their duty to investigate." The NAC decision is NASD's final action.[33]

The Court of Appeals in its remand opinion identified subjective and objective components in an analysis of recklessness, and we acknowledge the Gebharts' assertions that they believed they had done enough to confirm the truthfulness of their statements to clients. We consider evidence of good faith to be relevant to a determination of whether a respondent acted with the requisite state of mind. That evidence must be considered with all other evidence of knowledge or recklessness because the reasonableness and, therefore, the credibility of that claim of good faith must be evaluated in light of the

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[33] See Philippe N. Keyes, Exchange Act Rel. No. 54723 (Nov. 8, 2006), 89 SEC Docket 792, 800 n.17, appeal filed, No. 07-15736 (11th Cir. Dec. 13, 2007); Chris Dinh Hartley, 57 S.E.C. 767, 776 (2004) ("[I]t is the NAC's conclusions that are before us for review, not those of the Hearing Panel."); NASD Code of Procedure Rule 9349(c) (providing that the NAC decision constitutes the final disciplinary action that is subject to review by the Commission). For the reasons given in the 2006 Opinion, we agree with the NAC's rejection of the Hearing Panel's finding.

circumstances of each case and in light of the conduct expected from a reasonable person.

The Court questioned whether the 2006 Opinion should be interpreted as holding that good faith cannot be a defense to a finding of scienter whenever the evidence indicates that the respondents lacked a "reasonable basis for recommending the [securities], because they failed to discharge [their] duty to investigate before making the recommendations."[34] The Court seems concerned that our view is that a good faith belief founded on negligent actions satisfies the recklessness prong of scienter. We take this opportunity to reiterate our adherence to the recklessness standard as an extreme departure from the standards of ordinary care and our view that negligence does not qualify as scienter.

Thus, the evidence the Gebharts forward to demonstrate their good faith beliefs is and should be part of the complete mix of facts bearing on an evaluation of their state of mind, but, in the end, a respondent's belief that he acted in good faith must be tested by reference to objective criteria; *i.e.*, the applicable standard of conduct is determined in accordance with the degree to which the respondent had acted extremely unreasonably. A respondent's asserted good faith belief is not plausible if he ignores facts that place him on notice of a risk of misleading clients.

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[34] *Gebhart v. SEC*, 255 Fed. Appx. at 256 (alterations in original).

The Court in remanding this proceeding recognized this when it said: "When warranted, the SEC is entitled to infer from circumstantial evidence that a defendant must have been cognizant of an extreme and obvious risk and reject as implausible testimony to the contrary."[35] The *Sundstrand* court also emphasized the need to refer to external standards when it originally defined recklessness,[36] and other courts have similarly identified the ultimate importance of objective measures in securities fraud cases.[37]

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[35] *Gebhart v. SEC*, 255 Fed. Appx. at 255; *see also Sundstrand*, 553 F.2d at 1047-48 (rejecting "as a matter of law" defendant's argument that he "genuinely forgot" to disclose material information based on circumstantial evidence that defendant "must have consciously decided not to disclose (and did not disclose)" the omitted information).

[36] 553 F.2d at 1045.

[37] *See Makor Issues*, 513 F.3d at 704 ("[A] popular definition of recklessness in this context [proof of scienter in a securities fraud case] is 'an extreme departure from the standards of ordinary care . . . to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it.' This looks like two different criteria – knowledge of the risk and how big the risk is – but as a practical matter it is only one because knowledge is inferable from gravity ('the danger was either known to the defendant or so obvious that the defendant must have been aware of it'). When the facts known to a person place him on notice of a risk, he cannot ignore the facts and plead ignorance of the risk.") (alterations in original); *SEC v. Infinity Group Co.*, 212 F.3d 180, 192 (3d Cir. 2000) ("The SEC argues that scienter is evidenced by [the issuer's] guarantees of high rates of return that were unsupported by any honest due diligence. The defendants, on the other hand, contend that their actions 'were entirely consistent

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Unlike the examples given by the *Sundstrand* court in which the subjective component would preclude liability for objectively reckless misconduct, the Gebharts do not claim that they "genuinely forgot" to disclose material information, *i.e.*, that their statements had no basis in fact. Rather, their claim is that they were not reckless because, even though they knew their representations were based primarily on Archer's assertions and the silence of others, they nonetheless thought that they had done enough. The Gebharts similarly argue that they were truly and completely unaware of the fraud that the principals of MHP were perpetrating, that they were victims themselves of that fraud, and that they therefore lacked scienter. As the Gebharts assert, "It is simply implausible to suggest that the Gebharts knew or suspected that MHP would be unable to repay these loans while, at the same time, loaning it money."

These arguments are insufficient. As discussed above, the Gebharts made no meaningful attempts to confirm the validity of their assertions to clients that the Notes would be fully secured. They made these unsupported representations to clients despite not knowing whether they were true or false and despite

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with the fact that they believed their representations . . . [to be] true.' However, good faith, without more, does not necessarily preclude a finding of recklessness. Therefore, even if the defendants believed [the] investments were sound, they may still be liable for securities fraud if their belief was based upon nothing more than a reckless disregard of the truth.").

having several and varied reasons to doubt the truth of their own statements. Our *de novo* review of the evidence in this case therefore leads us to conclude that, contrary to the Gebharts' assertions, they must have known when they made their misrepresentations that their actions presented an unacceptable danger of misleading their clients.

Moreover, accepting *arguendo* that the Gebharts were unaware of MHP's fraud, this does not alter our conclusion: the Gebharts face liability not because they knew of or failed to discover MHP's fraud, but because they made specific representations to clients about the security of the Notes without taking any basic steps to verify the truthfulness of those representations. Even if the Gebharts were unaware of MHP's actual fraud, we conclude that they still must have known of the risk of misleading their clients given their extreme departure from the standards of ordinary care. The Gebharts are legally bound as knowing that the representations were false.[38]

We therefore conclude that the Gebharts made material misrepresentations during the offer and sale

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[38] *Cf.* W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS 741-42 (5th ed. 1984) (noting that, in context of tort of intentional misrepresentation, sufficient intent is found where the defendant made the statement knowing it to be false, without any belief as to its truth, with reckless disregard whether it be true or false, knowing he had no sufficient basis of information to justify the statement and conscious ignorance of the truth.); RESTATEMENT (SECOND) OF TORTS § 526 (1977).

of the MHP Notes. We also conclude that the Gebharts – who ignored obvious risks, failed to make obviously necessary inquiries, and were aware that their recommendations were based primarily on Archer's statements and a failure of other parties, particularly their firm, to alert them to problems – acted recklessly and therefore with scienter. Their conduct was an extreme departure from the standard of care that presented a danger of misleading buyers of which the Gebharts must have been aware. We therefore sustain NASD's finding that the Gebharts thereby violated Exchange Act Section 10(b), Exchange Act Rule 10b-5, and NASD Conduct Rules 2120 and 2110.[39]

IV.

Exchange Act Section 19(e)(2) directs our review of the sanctions NASD imposed. We may reduce or set aside sanctions imposed by NASD if we find, having due regard for the public interest and the protection of investors, that the sanctions are excessive or oppressive or impose an unnecessary burden on competition.[40] NASD imposed two associational

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[39] Misrepresentations and omissions are inconsistent with just and equitable principles of trade and therefore violate NASD Conduct Rule 2110. *Robert Tretiak*, Exchange Act Rel. No. 47534 (Mar. 19, 2003), 79 SEC Docket 3166, 3180.

[40] 15 U.S.C. § 78s(e)(2). The Gebharts do not claim, and the record does not show, that NASD's action imposed an undue burden on competition.

bars upon Gebhart: one for having sold unregistered securities and having engaged in private securities transactions, and another for having committed fraud. Donna Gebhart received a one-year suspension and a $5,000 fine for selling unregistered securities and engaging in private securities transactions as well as a separate one-year suspension and a $10,000 fine for the fraud. In the 2006 Opinion, we found that "the sanctions NASD imposed against the Gebharts are neither excessive nor oppressive, and we sustain NASD's findings of violation and imposition of sanctions." The Court of Appeals vacated only those sanctions related to the fraud.[41] Therefore, Gebhart is already subject to a bar, and Donna Gebhart was already subject to a one-year suspension as well as a fine. We consider only whether NASD's imposition of additional sanctions for the fraud is excessive or oppressive. For the reasons below, we find that it is not, and we sustain NASD's decision in this regard.

For reckless or intentional misrepresentations or omissions of material fact, the NASD Sanction Guidelines recommend a fine between $10,000 and $100,000 and a suspension between ten business days and two years; in egregious cases, the Guidelines recommend a bar.[42] NASD found that Gebhart's conduct

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[41] The Court "reverse[d] the SEC's scienter determinations with respect to Section 10(b), Rule 10b-5 and NASD Conduct Rule 2120 [and] vacate[d] the sanctions based thereon. . . ." *Gebhart v. SEC*, 255 Fed. Appx. at 256.

[42] NASD Sanction Guidelines 96 (2001 ed.).

was egregious in light of its analysis of the general principles applicable to all sanctions determinations under the Guidelines; however, NASD found that Donna Gebhart "played a less substantial role" and did not find her conduct to be egregious. In making its sanctions determination, NASD found it aggravating that the Notes were unregistered securities, that the Gebharts created the impression that their firm sanctioned their sales of MHP Notes, that the Gebharts' conduct resulted in monetary gain, and that the sales resulted in injury to investors.

NASD also considered several factors that the Gebharts argue should serve to mitigate sanctions. NASD accepted that "the preponderance of the evidence does not demonstrate that the respondents concealed their activities" from their firm. NASD also considered the Gebharts' efforts to help their customers reclaim a large portion of their investments and concluded those efforts were only "slightly mitigating," given that "the Gebharts' remedial efforts occurred only after MHP collapsed, which we view as the functional equivalent of detection, and therefore were not purely voluntary on their part." NASD also noted that part of the investors' recovery was funded by pursuing litigation against the Gebharts, which "is not what we consider to be remedial conduct." NASD also gave only little mitigative value to the Gebharts' professed remorse, which NASD found to be "dampened" by the Gebharts' attempts to shift blame to others involved, and to evidence of the Gebharts' cooperation with NASD's investigation,

which NASD determined was "not substantial enough to be mitigating."[43]

We conclude that NASD appropriately weighed the aggravating and mitigating factors relevant to imposing sanctions for fraud under its Sanction Guidelines. The Gebharts sold over $2 million in MHP Notes to numerous customers over an extended period based on reckless misrepresentations. The Notes were unregistered and, at least in later years, were unsecured. The Gebharts earned over $100,000 in commissions from these sales, while their customers incurred losses.

Moreover, we can find no fault with NASD's conclusion that the mitigating factors identified by the Gebharts do not outweigh the aggravating circumstances present in this case.[44] As we noted in the 2006 Opinion, efforts to help defrauded customers recover their losses are acknowledged and encouraged, but those efforts do not always justify a

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[43] The Gebharts point to no evidence that contradicts the NAC's finding that their cooperation was not substantial enough to be mitigating.

[44] *See, e.g., Michael A. Rooms*, 85 S.E.C. Docket 444, 450 (Apr. 1, 2005) (upholding bar notwithstanding arguments, among others, that applicant lacked disciplinary history and customer complaints, cooperated with investigation, and assertedly served as an "unwitting pawn" of another applicant involved in fraud), *aff'd*, 444 F.3d 1208, 1214-15 (10th Cir. 2006).

reduction in sanctions.[45] The sincerity of the Gebharts' contrition is lessened considerably by their continued objection that "it is simply unfair and unjust to lay at the Gebharts' doorstep the entirety of the misconduct of others that directly and more profoundly contributed to the resulting losses to the Gebharts' clients."[46] Although we recognize that the Gebharts' disciplinary record was "unblemished" before these proceedings, we have consistently held that lack of disciplinary history is not a mitigating factor because "an associated person should not be rewarded for acting in accordance with his duties as a securities professional."[47]

As NASD noted in its decision, "[d]isciplinary sanctions are remedial in nature and are designed to deter future misconduct and improve overall business standards in the securities industry." The risk posed to the investing public by associated persons who

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[45] *See Hartley*, 83 SEC Docket at 1247 ("We do not consider that [respondent] is deserving of a reduction in sanctions because his clients may be able to recover some of their losses.").

[46] *Mike K. Lulla*, 51 S.E.C. 1036, 1040 (1994) (upholding bar because "the fact that others also might have been remiss in their duties does not mitigate [respondent's] responsibility"); *see also Castle Securities Corp.*, Exchange Act Rel. No. 52580 (Oct. 11, 2005), 86 SEC Docket 1466, 1472 (barring applicant based in part on finding that applicant "sought to shift the blame" for its violations on others "instead of accepting responsibility for its violations").

[47] *Dennis Todd Lloyd Gordon*, Exchange Act Rel. No. 57655 (Apr. 11, 2008), 93 SEC Docket 5055, 5116 (citing *Keyes*, 89 SEC Docket at 801 n.20).

engage in fraud is profound and obvious. As we noted in the 2006 Opinion, "conduct that violate[s] the anti-fraud provisions of the federal securities laws is especially serious and subject to the severest of sanctions under the securities laws."[48] Under these circumstances, we concur in NASD's determination that Gebhart's misconduct demonstrates that he poses too great a risk to the investing public to be permitted to remain in the securities industry.

Although we recognize that Gebhart is already subject to a bar for having engaged in other violations of the securities laws and NASD rules, the additional bar for fraud is meaningful because Gebhart may eventually apply for reinstatement, and the basis for his disqualification from association will be relevant to his application.[49] Moreover, the bar NASD imposed upon Gebhart is appropriate because it will serve as a

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[48] *Marshall E. Melton*, 56 S.E.C. 695, 713 (2003).

[49] Under NASD's By-Laws, art. III, § 3(d), an NASD member firm may apply to NASD for permission to employ a representative subject to an associational bar. The By-Laws state that, in deciding whether to approve the application, NASD's Board of Governors may conduct an "inquiry or investigation into the relevant facts and circumstances," which may include "the background and circumstances giving rise to the failure to qualify or disqualification." *See also* Exchange Act Section 15A(g)(2), 15 U.S.C. § 78o-3(g)(2) (authorizing the Commission to direct NASD to "deny membership to any registered broker or dealer, and bar from becoming associated with a member any person, who is subject to a statutory disqualification" where doing so is "necessary or appropriate in the public interest or for the protection of investors").

deterrent to others who may be inclined to wholly abdicate their responsibilities to investors, thereby protecting the investing public by encouraging associated persons to make representations about, and recommendations of, securities to their clients only when they have a reasonable basis for doing so.[50]

For similar reasons, we believe the sanctions NASD imposed upon Donna Gebhart also serve an important remedial purpose without being punitive. NASD found that a one-year suspension and a $10,000 fine was appropriate given Donna Gebhart's "less substantial role" in the conduct at issue. These sanctions are well within the range provided for reckless misrepresentations in the Sanction Guidelines and will encourage Donna Gebhart and other representatives to consider more seriously their obligations to customers. We conclude, therefore, that the sanctions imposed by NASD to redress the risk posed by the Gebharts serve the public interest and are neither excessive nor oppressive.

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[50] In making this determination, we are mindful that although "'general deterrence is not, by itself, sufficient justification for expulsion or suspension . . . it may be considered as part of the overall remedial inquiry.'" *PAZ Secs.*, 494 F.3d at 1066 (quoting *McCarthy v. SEC*, 406 F.3d 179, 189 (2d Cir. 2005)).

We therefore sustain NASD's findings of violation and imposition of sanctions.[51] An appropriate order will issue.

By the Commission (Chairman COX and Commissioners CASEY, AGUILAR, and PAREDES; Commissioner WALTER not participating).

Florence E. Harmon
Acting Secretary

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[51] We have considered all of the arguments of the parties. We reject or sustain them to the extent that they are inconsistent or in accord with the views expressed in this opinion.

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 58951/November 14, 2008

Admin. Proc. File No. 3-11953r

In the Matter of the Application of

ALVIN W. GEBHART, JR.
and
DONNA T. GEBHART

c/o Charles F. Goria
Goria, Weber & Jarvis
1011 Camino Del Rio South, Suite 210
San Diego, CA 92108

For Review of Disciplinary Action Taken by NASD

ORDER SUSTAINING DISCIPLINARY ACTION

On the basis of the Commission's opinion issued this day, it is

ORDERED that the disciplinary action by NASD against Alvin W. Gebhart, Jr. and Donna T. Gebhart, and NASD's assessment of costs be, and they hereby are, sustained.

By the Commission.

Florence E. Harmon
Acting Secretary

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

Alvin W. Gebhart, Jr.; Donna T. Gebhart, *Petitioners*, v. Securities and Exchange Commission, *Respondent.*	No. 06-71021 SEC No. CRD1005905. OPINION

On Petition for Review of an Order of
the Securities & Exchange Commission.

Argued and Submitted Oct. 18, 2007.
Filed Nov. 21, 2007.

Before: Pregerson, Hawkins and Fisher,
Circuit Judges.

COUNSEL

Charles F. Goria, Esq., La Mesa, CA, for Petitioner.

Randall Quinn, Atty., William K. Shirey, SEC-Securities & Exchange Commission, Washington, DC, for Respondent.

MEMORANDUM*

Alvin Gebhart and Donna Gebhart ("the Gebharts") bring this petition for review of a Securities and Exchange Commission ("SEC") order imposing sanctions against them for fraudulently offering securities in violation of Section 10(b) of the Securities and Exchange Act of 1934, SEC Rule 10b-5 and NASD Conduct Rule 2120. *See* 15 U.S.C. § 78j; 17 C.F.R. § 240.10b-5. We have jurisdiction pursuant to 15 U.S.C. § 78y(a)(1). We reverse in part, affirm in part and remand.

The Gebharts contend that the SEC erred in determining that they acted with scienter. We review the SEC's factual findings for substantial evidence. 15 U.S.C. § 78y(a)(4). We set aside the SEC's conclusions of law if they are "'arbitrary, capricious, or otherwise not in accordance with law.'" *Ponce v. SEC,* 345 F.3d 722, 728 (9th Cir.2003) (quoting *Rutherford v. SEC,* 842 F.2d 214, 215 (9th Cir.1988)).

Scienter may be established by showing that the defendant acted recklessly. *Hollinger v. Titan Capital Corp.,* 914 F.2d 1564, 1568-69 (9th Cir.1990) (en banc). Recklessness in this context is "a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that

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* This disposition is not appropriate for publication and is not precedent except as provided by 9th Cir. R. 36-3.

is either known to the defendant or is so obvious that the actor must have been aware of it." *Id.* at 1569 (quoting *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1045 (7th Cir.1977)). When warranted, the SEC is entitled to infer from circumstantial evidence that a defendant must have been cognizant of an extreme and obvious risk and reject as implausible testimony to the contrary. *See Vernazza v. SEC*, 327 F.3d 851, 860-61 & n. 8 (9th Cir.2003); *In re Software Toolworks Inc.*, 50 F.3d 615, 627 (9th Cir.1994).

The objective component of scienter asks what a reasonably prudent securities professional under the circumstances would have done. *SEC v. Dain Rauscher, Inc.*, 254 F.3d 852, 856-57 (9th Cir. 2001). As securities professionals, the Gebharts had an "obligation to investigate" the securities they recommended and make an independent investigation adequate to provide them with a reasonable basis for believing that their representations were "truthful and complete." *See id.* at 857-58. The subjective component looks at an actor's actual state of mind at the time of the relevant conduct. *See In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 977 (9th Cir.1999) (requiring "some degree of intentional or conscious misconduct").

The SEC failed to find that the Gebharts *must* have known that their actions presented a danger of misleading their clients. Rather, the SEC's order is phrased in terms of what a reasonable securities salesperson *should* have recognized. We decline the SEC's invitation to construe its order as having

implicitly made the requisite finding. We also question the SEC's contention that the Gebharts are foreclosed from establishing good faith as a defense to scienter simply if they did not have a "reasonable basis for recommending the [securities], because they failed to discharge [their] duty to investigate before making the recommendations." Taken literally, this would seem to eliminate the subjective component of recklessness in failure-to-investigate cases. *See SEC v. Rubera,* 350 F.3d 1084, 1094 (9th Cir.2003) ("Reckless conduct must be something more egregious than even 'white heart/empty head' good faith and represents an extreme departure from the standards of ordinary care such that the defendant must have been aware of it."). The SEC should address this question on remand.

Accordingly, we reverse the SEC's scienter determinations with respect to Section 10(b), Rule 10b-5 and NASD Conduct Rule 2120; vacate the sanctions based thereon; and remand to the SEC for further findings on the factually intensive question of whether the Gebharts acted with the requisite scienter. *Cf. Urbina-Osejo v. INS,* 124 F.3d 1314, 1318 (9th Cir.1997). We retain jurisdiction over any subsequent petition for review.

The Gebharts' claims of error with respect to NASD Conduct Rule 3040 are without merit. The parties shall bear their own costs.

REVERSED IN PART, AFFIRMED IN PART AND REMANDED.

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 53136/January 18, 2006

Admin. Proc. File No. 3-11953

In the Matter of the Application of

ALVIN W. GEBHART, JR.
and
DONNA T. GEBHART

c/o Charles F. Goria
Goria & Weber
7863 La Mesa Blvd. Suite 201
La Mesa, CA 91941

For Review of Disciplinary Action Taken by NASD

OPINION OF THE COMMISSION

REGISTERED SECURITIES ASSOCIATION – REVIEW OF DISCIPLINARY PROCEEDING

Violations of Securities Laws and Conduct Rules

Fraudulent Sale of Securities

Sale of Unregistered Securities

Failure to Provide Written Notice to, and Obtain Prior Approval from, Member Firm Employer Regarding Private Securities Transactions

Registered representatives of member firm of registered securities association engaged in

private securities transactions without giving prior written notification to, or obtaining prior approval from, member; sold unregistered securities; and made material misrepresentations and omissions in the sale of securities. *Held,* association's findings of violation and the sanctions imposed are sustained.

APPEARANCES:

Charles F. Goria, of Goria and Weber, for Alvin W. Gebhart, Jr. and Donna T. Gebhart.

Marc Menchel, James S. Wrona, and *Michael J. Garawski,* for NASD.

Appeal filed: June 15, 2005
Last brief received: September 21, 2005

I.

Alvin W. Gebhart, Jr. ("Gebhart") and his wife Donna T. Gebhart ("D. Gebhart"), both formerly associated with Mutual Service Corporation ("MSC"), an NASD member firm, appeal from NASD disciplinary action. NASD found that, from 1997 to 2000, the Gebharts violated the antifraud provisions and registration requirements of the federal securities laws, as well as NASD rules, in offering and selling over $2 million in unregistered promissory notes.[1]

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[1] NASD found that the Gebharts violated Section 5 of the Securities Act of 1933 (requiring registration of certain securities), Section 10(b) of the Securities Exchange Act of 1934

(Continued on following page)

NASD barred Gebhart and fined D. Gebhart $15,000 and suspended her for one year.[2]

In its decision, NASD found that the promissory notes were securities, that no registration statement was in effect as to the notes, and that no exemption applied to the Gebharts' sales. NASD found further that the sales of the notes constituted private securities transactions and that the Gebharts neither provided MSC with written notice of the sales nor obtained MSC's prior, written approval as required by NASD rules. Additionally, NASD found that the Gebharts violated the antifraud provisions by, among other things, recklessly representing to their clients that the notes would be secured by deeds of trust on real property that contained sufficient equity to pay all claims in the event of default, when, in fact, deeds of trust for most of the notes were never recorded and the properties were substantially overencumbered, with the result that the notes were generally

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and Rule 10b-5 thereunder (prohibiting fraud in the offer and sale of securities), and NASD Conduct Rules 2110 (requiring adherence to just and equitable principles of trade), 2120 (prohibiting fraud in the offer and sale of securities), and 3040 (prohibiting involvement in a private securities transaction outside the regular course or scope of employment without providing prior written notice to the member firm).

[2] NASD imposed two separate one-year suspensions on D. Gebhart (one year for private securities transactions and sales of unregistered securities and one year for violations of federal and NASD antifraud provisions) that were to be served concurrently. NASD also assessed costs against the Gebharts, jointly and severally, in the amount of $5,141.21.

unsecured. We base our findings on an independent review of the record, except with respect to those findings not challenged on appeal.

II.

This case involves promissory notes issued by MHP Conversions, LLC ("MHP"). MHP was formed in late 1996 to facilitate the conversion of mobile home parks to resident ownership by Community Service Group ("CSG"). CSG, owned by James Scovie and his wife, would identify the owners of mobile home parks and solicit their interest in selling the park, meet with residents and solicit their interest in purchasing the park using various "special financing" options, and broker the transfer of ownership. By 1995, CSG began effecting the transfer of ownership by purchasing the parks itself and then helping the residents buy the property from CSG. MHP was created by Scovie and his associate, a real estate broker named David Mounier, supposedly to facilitate this operation by serving as the issuer of promissory notes that were sold to individual investors to raise the funds necessary for the purchases of these parks. MHP does not appear to have had any employees of its own and was operated by Scovie and CSG personnel in the CSG office.

The Promissory Notes Issued by MHP

The notes issued by MHP had one-year terms (because closing was normally expected to occur

within one year of the notes' issuance) and paid interest rates of 18% for new investments and 14% on reinvested funds.[3] Each promissory note stated that it would "ultimately be secured by a deed of trust" on the park to be purchased, but that "[u]ntil such time as said deed of trust is recorded, the sole asset of [the issuer] will be a deed of trust for the property known as Eastern Trailer Park . . . in the amount of $100,000."[4] The notes also stated that they were "non-recourse to Payor," *i.e.*, the notes on their face warned investors that their only remedy for default was against the property securing the note and not against the issuer. No registration statement was filed with the Commission by MHP for the notes it issued.

The record is ambiguous as to whether MHP was conducting a legitimate business during the period at issue. The record indicates that, for most of the three years of MHP's existence, noteholders received their

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[3] New investments earned 11% interest per annum, calculated and paid monthly, and a 7% "bonus" paid at maturity; clients who reinvested their funds after maturity could choose between earning 10% per annum with a 4% maturity bonus, or 11% per annum with a 3% bonus. Before MHP was formed, CSG issued certain promissory notes with essentially identical terms, but those notes are not at issue in this proceeding, as explained in note 8, *infra*.

[4] All notes issued by MHP purported to be secured by this interest in Eastern Trailer Park, which was described only as "located at 213 El Cajon Blvd, El Cajon, CA consisting of a 33 space trailer park"; however, the record indicates that MHP never owned an interest in Eastern Trailer Park.

promised interest payments, and MHP returned the principal to at least some investors who decided not to reinvest their funds when their notes matured. However, the characteristics of the MHP note program are consistent with those of a "Ponzi" scheme, in which returns are paid to investors out of funds raised from subsequent investors, rather than from profits generated by any real business. Because the books and records of MHP are not part of the record, the source of funds used to pay investors is unknown.

Irrespective of the initial success of MHP, it is clear that MHP's latter years, at least, were marred by fraud: it is undisputed that very few of the deeds of trust purportedly securing the MHP notes were recorded, despite representations to the contrary. It is also clear that, by the time MHP ultimately collapsed in early 2000, most, if not all, of the mobile home parks supposedly serving as security for the MHP notes were substantially overencumbered.

The Gebharts Learn About the Trailer Park Note Program

Gebhart, who had worked for Prudential Insurance Company from 1980 to 1994, began working at Mutual of New York ("MONY") in early 1994 selling variable annuities and mutual funds.[5] While working

[5] Gebhart was registered as an investment company products/variable contracts representative. He became registered as a general securities representative on December 10, 1997.

at MONY, Gebhart met Jack Archer, a fellow MONY salesman.[6] Archer had learned about CSG's park-conversion business from Mounier, one of his financial advisory clients, and in 1994 began assisting CSG in finding buyers for the promissory notes. Gebhart testified that Archer, an ex-Marine and Vietnam veteran, was highly regarded by MONY office staff and supervisors, and that he "had no reason to think anything different of him."

In late 1995, Archer had a short discussion with Gebhart in which Archer briefly described CSG's trailer park program and asked if Gebhart would be interested in it.[7] Gebhart responded equivocally, but when Archer contacted him again to ask if he knew anyone who might be interested in investing, Gebhart said that he would call some of his clients and find out if they were interested in purchasing notes from Archer.[8]

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[6] Archer was a named respondent in these proceedings but defaulted and, based on that default, was barred by NASD from associating with any member firm.

[7] Gebhart testified that Archer described it as a "program that did mobile home park conversions where people became owners of their parks."

[8] By early 1996, Gebhart had introduced three of his clients to Archer, each of whom eventually purchased notes from Archer: one client invested $25,000 on January 19, 1996; another invested $10,000 on April 26, 1996; a third client invested $10,000 on May 10, 1996 and $20,000 on October 3, 1996. Gebhart received $5,720 as a "finder's fee" for introducing these clients to the program. Although NASD's complaint and

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The Gebharts Join MSC

In late January 1996, Gebhart left MONY to join MSC. Soon after, on February 14, 1996, D. Gebhart also became associated with MSC.[9] The Gebharts opened a branch office in Rancho Bernardo, California, where they sold insurance and mutual funds and provided financial planning services.

During their first year with MSC, the Gebharts received from MSC a compliance manual and marketing materials, and Gebhart acknowledged that he read and understood the compliance policies and procedures in the manual. Included in that manual was a requirement that "outside business activities must always be reported to the Compliance Department," and, in the case of private securities transactions, await written approval before proceeding to "engage in private securities transactions outside the regular course or scope of their association or employment." A later version of the manual, the contents of which the Gebharts acknowledged by signature in September 1996, further clarified MSC's

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the record developed encompass Gebhart's involvement in, and potential liability for, these earlier sales of CSG-issued notes, in its two decisions (issued by an NASD Hearing Panel and its National Adjudicatory Council), NASD based findings of violation exclusively on the Gebharts' actions with respect to the notes issued by MHP from 1997 to 2000.

[9] D. Gebhart was registered as an investment company products/variable contracts representative when she joined MSC; she became registered as a general securities representative on April 27, 1998.

policy on private securities transactions, noting that representatives may not offer any security not listed on MSC's approved product list, including "alleged non-securities 'deals,'" without "advance written specific permission" from MSC.

On October 2, 1996, the Gebharts themselves invested $7,000 in notes issued by CSG.[10] Soon after, on October 23, 1996, Archer contacted the Gebharts to ask if they were interested in selling notes directly to their clients. The Gebharts had a lengthy discussion with Archer about the details of the note program. Gebhart testified that, during that discussion, Archer "explained the entire program," including "the due diligence that [Archer] had done behind it and he explained that the firm running it had gone through the necessary documentations [sic], that it had been approved by the IRS to be held in pensions, other reinforcement docs, things like that." Gebhart also testified that Archer told the Gebharts that "all of the governmental agencies were involved, even San Diego County." According to D. Gebhart, Archer told them that "the parks were in good shape"; "had a lot of equity in them"; were only "45 to 55

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[10] The Gebharts also made five subsequent investments in notes issued by MHP: $5,939.51 on February 13, 1997; $6,462.17 on March 9, 1998; $13,417.92 on September 2, 1998; $6,918.98 on March 29, 1999; $15,000 on May 20, 1999; and $14,550.62 on September 30, 1999. Although the Gebharts' note purchases total nearly $70,000, the record indicates that some of these note purchases were simply reinvestments of funds from matured notes.

percent leveraged"; and "had ten investors or less [sic]" per park. D. Gebhart also testified that in that meeting she "wanted to make sure that these notes or trust deeds were secured and [Archer] assured us that they were always secured. . . . I don't remember word-for-word what the man said, but he came to us and he was a pension administrator, a Pacific Life former manager, and we always looked at him as being probably further up in the – obviously more experienced in stuff than we had [sic]."

Gebhart testified that Archer told the Gebharts that the notes did not present "a security issue" because they were second deeds of trust and the parks "always" had fewer than ten investors.[11] Gebhart also testified that Archer told him that, in 1994, Archer had a conversation about the notes with a MONY compliance officer, who told Archer the notes could be sold "without objection."[12] Nevertheless,

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[11] The Gebharts never knew, and never asked, about the holders of the first deeds of trust secured by the mobile home parks. They also never knew, or asked about, whether the properties were encumbered by any other liens.

[12] In a deposition in a related civil case, Archer testified that he approached a MONY compliance officer, whose name and appearance he forgot, about the notes at the conclusion of a compliance seminar in August 1994. Archer "told the gentleman that I had a client who was converting mobile home parks to resident ownership and that I was going to be or was considering raising – arranging loans between my two clients, Dave Mounier from Community Service Group and my other client base. . . ." The compliance officer asked several questions and supposedly concluded that "he did not see a problem with

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Archer suggested the Gebharts contact MSC's compliance department before selling the notes "to avoid the selling away problem" and encouraged the Gebharts to be open and forthcoming with their firm.

The Gebharts Contact MSC's Compliance Department

That same day, Gebhart telephoned MSC's compliance department and spoke to the Director of Compliance, Michael Poston. Gebhart testified that he had a relatively lengthy conversation with Poston in which Gebhart explained the program in detail, disclosed that he would be receiving commissions on the sales, and answered "a lot" of questions from Poston. According to Gebhart, Poston said the program "sounded like a good idea" and asked to see more information. Poston, on the other hand, testified that the call was "a casual five-minute conversation" in which Gebhart told him "very little" about the promissory notes. Although Poston's recollection of the phone call is markedly different from that of the Gebharts, the parties agree that Poston did not give permission to the Gebharts to sell the notes during that telephone call.

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it." However, Archer also testified that there was no discussion about whether the notes were securities, and admits that, although the compliance officer recommended that Archer run the program by the MONY compliance department, Archer never did so. It is undisputed that Archer never submitted written notice of his activities to MONY, and never received written approval from MONY to sell the notes.

The next day, the Gebharts sent a brief letter via overnight courier to Poston enclosing a package of materials about CSG and its mobile home park conversion business, which Archer had provided in his recent meeting with the Gebharts.[13] The Gebharts testified that they forwarded to Poston "everything that Mr. Archer gave [them]," including a sample promissory note and a "brochure" created by Scovie and Mounier that included a printout from CSG's website describing its park-conversion business, several local newspaper articles that reported successful park conversions, and several one-page descriptions of converted parks. Gebhart also recalled sending Poston a copy of "pro forma" financial information for one park conversion that provided a brief projected cash flow analysis and an investment summary that sketched the outlines of CSG's plan to borrow funds to convert the park. MHP was mentioned in these materials only in that the company's name appeared on the cover of the brochure along with CSG's. It is undisputed that Poston never responded to the Gebharts' letter and never gave either oral or written permission to the Gebharts to

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[13] The Gebharts' letter to Poston consisted of four sentences:

> Pursuant to our phone conversation, [sic] this morning, please find enclosed the information on the Trailer Park Program. Please review this information, and please let me know what you think of it.
>
> Should you have any questions, please do not hesitate to call me. Thank you.

sell the notes.[14] It is also undisputed that the Gebharts made no further efforts to inform Poston or anyone else in MSC's compliance department about their plans to sell the notes, and that no one in the firm's compliance department ever authorized those sales either orally or in writing.

The Gebharts Sell MHP Notes

Hearing nothing from Poston since their October 1996 phone call,[15] the Gebharts began offering and selling promissory notes issued by MHP to their clients in early 1997. All the clients to whom the Gebharts offered and sold MHP notes were

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[14] Poston's recollection of the materials he received differed from the Gebharts' description. Poston testified that the package contained only three or four newspaper articles and a few abstracts of converted parks; he "didn't know what to make of it," and thought that the "whole letter . . . looked like a joke, practically." The Hearing Panel made no credibility finding related to the telephone conversation between the parties, but found that it "believed [Gebhart's] testimony that the material he sent to Mr. Poston at Mutual Service included everything he had received from Mr. Archer. . . ." We need not resolve the disparity between the testimony of the Gebharts and Poston because, as we noted above, the parties agree on the critical facts: neither Poston nor anyone else in MSC's compliance department gave permission to the Gebharts to sell MHP notes either during the telephone call or in response to the Gebharts' letter.

[15] When asked why he waited a few months after calling Poston before making his first sale, Gebhart responded, "There was no – I don't know. There was no parks. There was no clients. There was nobody – we just didn't do it."

individuals. The Gebharts' presentations were based on the information they received from Archer, on the payment history of their own note, and on visits the Gebharts paid to two trailer parks.[16] When asked about what investigation he conducted before presenting the MHP notes to clients, Gebhart responded:

> I did visit two parks, the one in my town where I lived and also the one in El Cajon. I felt in talking with Jack [Archer] and his representations, the documentation that I had received from him, the things that I sent to Mutual Service Corporation letting them know, thinking if there was an issue, they would be in touch with me. If there wasn't [sic] something I wasn't doing right, they would say, "Fix this. Do that." I would do that. So up until the first note, I thought I had done what I believed was the proper due diligence.

Both of the Gebharts together usually made a presentation to clients regarding the notes and normally distributed copies of the CSG brochure and

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[16] Gebhart testified in a civil deposition in a related case:

> What we did is I went up to the Flinn Springs trailer park, drove in, looked around to see the quality of it, to see if it's there, if it's a bona fide piece of real estate, there were mobile homes on it, people living in those mobile homes, whether it was upkept – kept up. Same thing in Aviation. I drove in, looked around, see if there's people living there, if mobile homes were there. In fact, they were.

a sample MHP note to their clients.[17] The brochure briefly described CSG's business and included several local newspaper articles on CSG's park conversions and some cursory descriptions of properties converted by CSG; it contained no information on MHP other than its address and telephone number (which it shared with CSG) or on the MHP notes. Information on the MHP note program that clients received therefore came only from the sample MHP notes themselves and from oral presentations by the Gebharts.

The Gebharts considered the MHP notes to be one of a "variety of investment strategies" and offered it to their clients as one alternative that would "fit in [their] portfolio[s], based on their objectives." The Gebharts presented the MHP program as an option for some investors who needed a substantial, fixed monthly income. For example, investor Maribeth Trogdon, a recent widow with two dependent children whose only income was from a part-time teaching job, testified in a deposition in a related civil case that the Gebharts recommended that she invest a large portion (more than a third) of the life insurance

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[17] D. Gebhart testified that she considered Gebhart to be the "overseer" and her "mentor." He tended to do most of the talking during client presentations, but she did much of the "detail work." They shared responsibility for fielding client phone calls, reviewing correspondence and client account statements, and were "both familiar with their [clients'] investments or strategies," so that if Gebhart were unavailable, D. Gebhart could "answer their questions."

proceeds from her husband's death into MHP notes to replace her husband's income.[18] Notes that Trogdon made in preparation for the deposition state that "[t]he investment was presented to me as a proven, long term way for me to receive a substantial monthly income." Investors also testified that the Gebharts told them that the Gebharts had invested their own money in the notes and that the program had been so far successful. Investor Donald Townsend, a retiree looking to supplement his retirement income "to take care of the bills," testified that Gebhart represented that MHP was "basically solvent and steadily growing[,] obtaining more parks[,] and had been paying the monthly interest with no problems." At the hearing, Gebhart confirmed that he believed the trailer park program was a successful venture because he "didn't hear any complaints" from the three clients he had referred to Archer in early 1996.

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[18] Although NASD declined to rely on investor testimony in its decision because the Hearing Panel made no credibility determinations as to investor testimony given at the hearing or in civil depositions, we choose to include it. The Hearing Panel made no finding that the investors' testimony was unreliable and actually made use of investor testimony in at least one instance in its decision. Further, where, as here, there are similarities among the investors' testimony regarding the salespersons' behavior, the reliability of that testimony is strengthened. *See Frank J. Custable, Jr.*, 51 S.E.C. 643, 648 (1993). Given that the Gebharts' own testimony is also consistent with that of the investors, we find no reason to ignore this evidence.

Investors also testified that the Gebharts informed them that the MHP notes would be secured by recorded deeds of trust, and that the parks would serve as sufficient collateral to secure all investments in the event of default. For example, Townsend testified, "I was told that [MHP] would purchase the mobile home parks with the money that's being loaned to them and that they would eventually secure the property with trust deeds. . . ." Investor Larry Tickel, a disabled former Wal-Mart store manager, testified that the Gebharts assured him that "there was no risk because [the note] was secured by a deed of trust and then that [the parks] would not be overbought. So that way, if they had to sell the place, we would still get our money back."[19] The Gebharts' recollection of their statements to clients is consistent with the testimony of their clients. Gebhart testified that he told clients, "If they invested into [an MHP note] they would get a recorded deed of trust. If the worst case scenario came down they would be part owners of that park." D. Gebhart similarly testified, "If [clients] asked us about it, either [Gebhart] or I would say the type of thing it is; they are mobile home park conversions. We would give them the knowledge we had about them and we would tell them that they would own a piece of the park. . . . [I]f it was like worst case scenario, if something

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[19] Following up, the NASD attorney asked Tickel, "Is that what Mr. Gebhart told you, that there was no risk?" Tickel responded, "Right."

happened and the park were to default, we all would own a portion and we could be able to sell the park and we would all get cashed out."

The Gebharts did not have, and did not pass on to clients, any specific information about MHP's or CSG's management, income, or financial condition. Nor did the Gebharts possess, determine, or recite to clients any specific information about the properties that were to be purchased with the investors' borrowed funds other than the address of the parks to be purchased. According to D. Gebhart, she didn't require more specific information because "[i]t was always our understanding that [MHP] wouldn't have done a conversion on a park that wasn't – that didn't have good cash flow and that would be a deal worth them doing." D. Gebhart testified that she simply "had faith with everybody that was involved that it was a good program."

When a client decided to purchase an MHP note, the Gebharts would collect a check from the client, make a copy of that check, and then call Archer. Archer, who had told the Gebharts not to contact MHP or CSG directly, served as the "middle man" between the Gebharts and MHP/CSG: Archer would deliver the clients' checks to MHP and then return a promissory note to the Gebharts, who would then transmit the MHP note to their clients, usually by

mail.[20] MHP did not provide copies of the deeds of trust supposedly securing the notes unless an investor requested one, and very few investors made such a request.[21] The Gebharts recalled seeing at least one copy of a client's trust deed, but did not recall seeing any recording information. The Gebharts testified that they maintained records of the MHP note purchases in their client files and in their office transaction logs.

The Gebharts understood that Archer was sharing his commissions with them.[22] For investments of new money into an MHP note, Archer paid the Gebharts a commission of 6-7%; for MHP notes purchased with reinvested funds, the Gebharts

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[20] The Gebharts corresponded with their customers using letterhead that stated "Securities offered by Mutual Service Corporation." At least one investor testified in a deposition in a related civil case that, when she asked the Gebharts how she could be sure the money she was putting toward the MHP note "isn't being sent to Tahiti," the Gebharts replied that MSC "looks at all our business . . . and would tell them if there was anything incorrect by law."

[21] The Gebharts never requested, nor received, a copy of the deeds of trust securing their own promissory notes.

[22] The record contains inconsistencies about the Gebharts' knowledge of the commissions that they understood Archer to be earning. Gebhart testified that before he sold his first MHP notes, he understood that he "would be getting 50 percent" of what Archer made. However, Gebhart also testified that he did not know how much Archer was being paid by MHP and did not ask, considering it a "private issue."

received 3-4%.[23] Archer paid the Gebharts their commissions with checks drawn on his personal bank account.

MSC's 1997 Audit of the Gebharts' Office

From January through August 1997, the Gebharts sold eleven MHP notes totaling $378,195, including a $5,939.51 investment of their own money. On August 20, 1997, the Gebharts completed a Compliance Survey in which they acknowledged that they received and understood MSC's compliance procedures, notified MSC of any outside business relationships, and did not engage in any private securities transactions. The Gebharts did not report their MHP note sales, or the commissions they earned for those sales, to MSC.[24]

On November 17, 1997, MSC audited the Gebharts' office as part of MSC's normal practice. The Gebharts testified that they made available to the auditor their transaction logs, which contained line item entries for their clients' MHP note purchases, and client files, some of which contained copies of MHP notes. If the auditor noticed the MHP

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[23] Gebhart testified that Archer renegotiated the amount of commission the Gebharts were paid: it decreased from 7% to 6% for new money and from 4% to 3% for reinvested money in January 1998; this seems to correspond to a decrease in commissions that MHP paid to Archer.

[24] The Gebharts earned $7,401.00 in commissions for their sales in 1997.

transactions, he did not raise any concerns. At this time, the Gebharts each completed an audit questionnaire that requested information on whether the Gebharts, among other things, received compensation from outside sources, participated in the offer of promissory notes, or split commissions with any person. The Gebharts checked "no" in response to all of these questions and did not otherwise report any of their MHP transactions on the form.

The Gebharts' Sale of MHP Notes in 1998 and 1999

The Gebharts continued to offer and sell MHP notes to their clients throughout 1998: customers purchased over $425,000 in notes that year,[25] for which the Gebharts earned over $50,000 in commissions. Nevertheless, the Gebharts completed MSC's Compliance Survey in July 1998 in which they made no disclosures about their sales of MHP notes and certified that they had not engaged in any private securities transactions without written approval from MSC's Compliance Department.

On September 14, 1998, the Gebharts instructed their administrative assistant to contact MSC's operations department to inquire whether funds held in a tax-qualified, 403(b) retirement account could be used to purchase an MHP note. The Gebharts' assistant faxed a sample MHP note to a staff member in MSC's

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[25] This amount excludes the $36,469.60 that the Gebharts themselves purchased in 1998.

operations department, and, upon MSC's request, also provided MHP's contact information. On September 24, 1998, the Gebharts received a fax from the operations department approving the MHP notes for holding in a 403(b) account and giving instructions on filing the necessary paperwork before funds could be released. The client on whose behalf the Gebharts made this inquiry ultimately decided not to invest in the MHP notes, but Gebhart testified that two other clients later did so using retirement account funds, and the paperwork for these purchases cleared MSC's operations department without comment. It is undisputed, however, that MSC's compliance department, which was given the responsibility for approving outside business activities in the firm's compliance manual, was not involved in the review of these transactions; moreover, as the Gebharts' administrative assistant testified in a civil deposition, the inquiry to MSC's operations department was made for the sole purpose of finding out what paperwork was needed to effect the transaction.

On February 1, 1999, the Gebharts completed MSC Representative Questionnaires in anticipation of a second visit from MSC's auditor.[26] The Gebharts certified on the questionnaires that they had not

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[26] Although the Gebharts testified that, as with the 1997 audit, they made available to the auditor their transaction logs and client files that contained some evidence of MHP transactions, the auditor, if he took note of them, did not comment on the transactions.

engaged in any private securities transactions. These forms also asked whether the representative "issued or participated in any offering of general partnership interests, commercial paper, promissory notes, or joint venture participations" other than through the firm; both the Gebharts checked "yes" and wrote in "2nd deeds of trust."[27] In response to this same question in 1997, the Gebharts had checked "no." When asked why he gave a different answer to the same question in 1999 than he did on an identical form in 1997,[28] Gebhart replied, "The only answer is I had a better understanding of the form then." D. Gebhart testified that in 1997 she believed the question sought information only on new activity that had not before been disclosed to MSC, whereas in 1999 she thought that because they "started doing more of them" they should disclose it on the form.[29]

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[27] Gebhart also added "Investment by Rep. & Clients" after "2nd deeds of trust" in her response to this question.

[28] As noted previously, in 1998 the Gebharts had also acknowledged by signature, on a different form, that they had "not engaged in private securities transactions as defined in MSC's Policy and Procedures Manual without written approval from the MSC Compliance Department."

[29] Although the auditor testified that he discussed the "2nd deeds of trust" with the Gebharts and was told that the Gebharts and "only a few" of their clients had invested in the deeds through a "third party," neither of the Gebharts recall the discussion with the auditor. It is undisputed, however, that the auditor conducted no further inquiry into the matter and did not raise the issue with Poston, his supervisor. The Hearing Panel

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In late 1999, the Gebharts each completed a Compliance Survey in which they acknowledged that they had not engaged in any private securities transactions without prior written approval from MSC's Compliance Department.[30] The Gebharts sold over $1.5 million in MHP notes in 1999,[31] earning $75,723.00 in commissions.

MHP Collapses

The Gebharts sold another $213,731.51 in MHP notes in early 2000. On January 15, 2000, Scovie was diagnosed with brain cancer. In April 2000, MHP ceased making interest payments on the notes. In an April 4, 2000 letter to MHP noteholders, Scovie stated that his absence from the daily operations of CSG and MHP was causing "cash flow problems" and that he intended to liquidate all assets and distribute proceeds to the companies' creditors. The Gebharts learned in May 2000 that MHP had secured only $605,000 worth of notes with recorded deeds of trust and that, as they reported in a letter to MSC

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found it "unlikely that [the auditor] irrefutably remembered the audit and the conversations that he had with the Respondents."

[30] MONY's compliance department became aware of Archer's sales of MHP notes in mid-1999, informed Archer that his activities constituted private securities transactions, and insisted that he terminate his relationship with MHP. Archer did not tell the Gebharts about MONY's determination.

[31] This figure excludes the $36,469.60 in MHP notes the Gebharts purchased themselves.

describing the collapse of the MHP note program, "all of the mobile home parks appear[ed] to be substantially overencumbered." When MHP collapsed, the Gebharts' clients had over $1.5 million invested in outstanding notes, and the Gebharts themselves had about $36,000 invested. MSC launched an investigation of the matter, with which the Gebharts fully cooperated, which resulted in their termination by MSC on August 11, 2000.

The Gebharts took steps to recover the money that they and their clients had invested, including eventually filing a petition for involuntary bankruptcy against MHP and suing their own professional liability insurer, with the result that the Gebharts' clients recovered approximately 84% of their losses. The Gebharts also may have recovered some portion of their own investment, although the record is unclear as to the extent of that recovery.[32]

III.

The Gebharts are charged with the fraudulent sale of unregistered securities without approval from

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[32] Although the record indicates that the Gebharts participated in the bankruptcy, they claimed below that they declined to recover the funds they had invested with MHP in order to maximize recovery by their clients. They further claim to have paid, out of their own funds, substantial legal fees to help their clients recover their investments. The Gebharts, however, have introduced no evidence to support these assertions, leaving us without a basis on which to credit them.

MSC, in violation of the federal securities laws and regulations and NASD rules. Because all of these violations depend upon a finding that the promissory notes issued by MHP were securities, we turn first to that question.

Securities Act Section 2(a)(1) defines the term "security" as, among other instruments, "any note."[33] In *Reves v. Ernst & Young,*[34] the Supreme Court stated that "the phrase 'any note' should not be interpreted to mean literally 'any note,' but must be understood against the backdrop of what Congress was attempting to accomplish in enacting the Securities Acts."[35] "Congress' purpose in enacting the securities laws was to regulate *investments,* in whatever form they are made and by whatever name they are called," and Congress "enacted a definition of 'security' sufficiently broad to encompass virtually any instrument that might be sold as an investment."[36] Thus, we focus on whether the notes in question resemble an investment.[37]

The "family resemblance" test adopted in *Reves* controls our inquiry into whether a note constitutes

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[33] 15 U.S.C. § 77(b)(a)(1).

[34] 494 U.S. 56 (1990).

[35] *Id.* at 63. *Reves* involved the definition of a security in the Exchange Act. The Court noted that the Securities Act contained a virtually identical definition and reaffirmed that the coverage of the two statutes may be considered the same. *Id.* at 61 n.1.

[36] *Id.* at 61 (emphasis in original).

[37] *McNabb v. SEC,* 298 F.3d 1126, 1131 (9th Cir. 2002).

an investment and is therefore subject to regulation under the securities laws. The test identifies four relevant factors: 1) the motivations that would prompt a reasonable seller or buyer to enter into the transaction; 2) the plan of distribution of the instrument; 3) the reasonable expectations of the investing public; and 4) the presence or absence of a factor such as another regulatory scheme that significantly reduces the risk of the instrument, thereby rendering application of the federal securities laws unnecessary.[38] A note is presumed to be a security under this test,[39] and that presumption may be rebutted only if the four-factor analysis reveals either that the note bears a strong resemblance to certain types of notes recognized as nonsecurities or that the note should be added to this list.[40]

The Gebharts state incorrectly that "the initial test is whether the subject instrument is includable

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[38] 494 U.S. at 66-67.

[39] *Id.* at 67.

[40] *Id.* The Court deemed the following notes to be non-securities: the note delivered in consumer financing, the note secured by a mortgage on a home, the short-term note secured by a lien on a small business or some of its assets, the note evidencing a character loan to a bank customer, a short-term note secured by an assignment of accounts receivable, the note that simply formalizes an open-account debt incurred in the ordinary course of business, and the note evidencing a loan by a commercial bank for current operations. *Id.* at 65 (quoting *Exchange Nat'l Bank v. Touche Ross & Co.*, 544 F.2d 1126, 1138 (2d Cir. 1976) and *Chemical Bank v. Arthur Anderson & Co.*, 726 F.2d 930, 939 (2d Cir. 1984)).

within one of six categories of notes that are automatically deemed to be nonsecurities" and that the "second test" is the "four-part" or "family resemblance" test. The four-factor inquiry governs whether a note resembles one of the categories of notes deemed nonsecurities as well as whether a note should be added to that list because "[i]t is impossible to make any meaningful inquiry into whether an instrument bears a 'resemblance' to one of the instruments identified [as non-securities] without specifying what it is about *those* instruments that makes *them* non-'securities.'"[41] Accordingly, we apply the four-factor analysis to evaluate the Gebharts' claim that the notes, as notes purportedly secured by deeds of trust on real property, fall within the category of "notes secured by a mortgage on a home" that are deemed non-securities.[42]

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[41] *Reves*, 494 U.S. at 65-66 (emphasis in original); *see also id.* at 67 (stating that a showing that a note bears a strong resemblance to one of the categories of notes considered non-securities is to be made "in terms of the four factors" identified by the Court).

[42] *Cf. SEC v. Wallenbrock*, 313 F.3d 532, 537-40 (9th Cir. 2002) (applying four-factor test to notes ostensibly secured by accounts receivable even though defendant argued that the notes were exactly like the "short-term notes secured by an assignment of accounts receivable" excluded from the definition of a security in *Reves*); *see also Mercer v. Jaffe, Snider, Raitt and Heuer, P.C.*, 736 F. Supp. 764, 769 (W.D. Mich. 1990) (rejecting argument that the "first mortgage notes" at issue were per se non-securities and that the court need not even consider the four-factor "family resemblance" test given that the Supreme Court listed "the note secured by a mortgage on a home" as a

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As discussed below, this four-factor analysis reveals that the MHP notes do not sufficiently resemble a "note secured by a mortgage on a home" to be considered a non-security under that category. The Supreme Court contemplated only mortgage-backed notes issued in the context of a traditional face-to-face transaction between a borrower and commercial or consumer lender.[43] We find, based on the four *Reves* factors, that the MHP notes do not fit within this classification.[44]

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non-security), *aff'd on other grounds sub nom. Schriemer v. Greenberg*, 931 F.2d 893 (6th Cir. 1991) (Table) and *aff'd on other grounds*, 933 F.2d 1008 (6th Cir. 1991) (Table).

[43] *See Mercer*, 736 F. Supp. at 769-70 (stating that the Supreme Court in *Reves* intended the example of a "note secured by a mortgage on a home" to apply only to mortgage-backed notes in the context of a traditional face-to-face loan transaction between a borrower and commercial or consumer lender, and concluding that, in terms of the *Reves* factors, the "first mortgage notes" at issue bore little resemblance to the mortgage-backed note given by a borrower to his lender in a typical home equity loan transaction); *see also Pollack v. Laidlaw Holdings, Inc.*, 27 F.3d 808, 812 (2d Cir. 1994) (finding, for reasons that would become clear as the court addressed the *Reves* factors, that the instruments at issue did not sufficiently resemble the traditional note secured by a home mortgage to be exempt from regulation under the securities laws).

[44] The Gebharts argue, citing *Proschaska & Assocs. v. Merrill Lynch Pierce Fenner & Smith, Inc.*, 798 F. Supp. 1427, 1430 n.2 (D. Neb. 1992), that we must consider the notes on the basis of what they would have been but for the fraud and that, but for the fraud, the notes resembled "notes secured by a mortgage on a home." The *Reves* analysis, however, demonstrates that the notes were bought and sold as "investments"

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1. Motivations of Seller and Buyer

The first *Reves* factor is an objective inquiry into "the motivations that would prompt a reasonable seller and buyer to enter into [the transaction.]"[45] The instrument is likely to be a security if the seller's purpose is to raise money for the general use of a business enterprise or to finance substantial investments and the buyer is interested primarily in the profit the note is expected to generate.[46] The note is less sensibly described as a security if the note is exchanged to facilitate the purchase and sale of a minor asset or consumer good, to correct for the seller's cash-flow difficulties, or to advance some other commercial or consumer purpose.[47]

a. Seller's motivation

MHP sold the notes to raise money for the general use of a business enterprise; it used the noteholders' funds to purchase trailer parks as part of its core business of converting such parks to resident ownership.[48] We reject the Gebharts' contention that

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regardless of the fraud. Thus, the notes are subject to regulation as securities. *See Reves* 494 U.S. at 68-69 (stating that the fundamental essence of a security is its character as an investment).

[45] *Wallenbrock*, 313 F.3d at 538 (alteration in original).

[46] *Reves*, 494 U.S. at 66.

[47] *Id.*

[48] *See Stoiber v. SEC*, 161 F.3d 745, 749-50 (D.C. Cir. 1998) (finding that the seller's "use of the note money to buy an

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this use is not a general business use because noteholders provided their funds "as purchase money loans for the purchase of specific real estate." The noteholders testified explicitly that they did not care in which park MHP invested their money. MHP's use of their money constituted a general business use notwithstanding that MHP purportedly gave each noteholder an interest in a specific park in return for their funds; at the core of the transaction, the noteholders, in return for a high rate of interest, provided MHP with funds for its business of financing trailer park purchases.[49]

b. Buyer's motivation

The noteholders' testimony that they invested in the notes for the promised 18% return in the form of

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inventory of commodities" was "appropriately viewed as a general business use" "[b]ecause the purchase of commodities for reselling was at the core of [seller's] business"); *Frank Thomas Devine*, Securities Exchange Act Rel. No. 46746 (Oct. 30, 2002), 78 SEC Docket 2528, 2536 (finding that the seller's use of investors' money to buy viatical insurance contracts was "appropriately viewed as a general business use" because the purchase of such contracts "was at the core of [seller's] business").

[49] *See Wallenbrock*, 313 F.3d at 538 (finding that an issuer sold notes for the general use of a business enterprise even though investors provided the issuer with half the cost of a specific account receivable and received a note purportedly secured by that receivable because, at the core of the transaction, the investors, seeking to make a significant profit, provided the issuer with cash for its business of buying accounts receivable).

interest payments establishes that the noteholders were interested primarily in the profit the notes were expected to generate.[50] "'[P]rofit' in the context of notes" means "'a valuable return on an investment,' which undoubtedly includes interest."[51] The noteholders' desire for a valuable return on an investment is further evidenced by their testimony that they viewed the notes as investments rather than real estate loans and purchased the notes as "part of my investment portfolio" or to "supplement my income with monthly distribution." Further evidence of the noteholders' investment intent stems from their reliance on the Gebharts for financial planning and investment advice and the Gebharts' recommendation of the notes in connection with this advice.[52] We reject the Gebharts' contention that a desire for profit did

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[50] *See John P. Goldsworthy*, Exchange Act Rel. No. 45926 (May 15, 2002), 77 SEC Docket 2025, 2035 (finding that the customers who purchased the notes were motivated by a desire for profit because most of the customers identified the promised ten percent interest rate as a primary reason for investing in the notes); *Devine*, 78 SEC Docket at 2536 (stating that the noteholders purchased the notes "with the expectation of profit based on the 21% to 25% interest rates purportedly offered").

[51] *Reves*, 494 U.S. at 68 n.4.

[52] *See Robin Bruce McNabb*, 54 S.E.C. 917, 922 (2000) (stating that the fact that the customers obtained the notes from a financial advisor as part of an investment portfolio is also evidence of investment intent); *Stephen J. Gluckman*, 54 S.E.C. 175, 180-81 (1999) (stating that further evidence of investment intent stemmed from the investors' reliance on the respondent, their "financial advisor," for recommendations and suggestions on instruments to add to their investment portfolios).

not motivate the noteholders because "they were not promised any capital appreciation; nor was the rate of interest keyed to the profits of the enterprise." In *Reves,* the Supreme Court declined to limit the definition of profit to either "capital appreciation" or "a participation in earnings."[53]

2. Plan of Distribution

The second *Reves* factor is an examination into the "plan of distribution" of the note "to determine whether it is an instrument in which there is common trading for speculation or investment."[54] The requisite "common trading" is established if the instrument is offered and sold to a broad segment of the public.[55] The Gebharts sold over 100 notes worth more than $2 million to about forty-five clients. Archer sold notes to a similar number of customers. We find that such sales constitute sales to "a broad segment of the

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[53] *Reves,* 494 U.S. at 68 n.4; *see also SEC v. Edwards,* 540 U.S. 389, 395-96 (2004) (rejecting notion that "profits" for purposes of determining whether an instrument constitutes an "investment contract" are limited to either capital appreciation or a participation in earnings).

[54] *Stoiber,* 161 F.3d at 750 (citing *Reves*); *McNabb,* 298 F.3d at 1132 (same). The Gebharts state incorrectly that a plan of distribution requires common trading for speculation and investment. *Reves* refers to common trading for speculation or investment. The noteholders bought the notes as investments. *See, e.g., infra* text preceding note 64.

[55] *Stoiber,* 161 F.3d at 750 (citing *Reves*); *McNabb,* 298 F.3d at 1132 (same).

public."[56] The fact that the investors who purchased notes from the Gebharts were not linked in any way except as customers of the Gebharts and MSC further supports this conclusion.[57] Accordingly, the distribution of the notes to a "broad segment of the public" establishes common trading.[58]

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[56] *See Jim Newcomb,* Exchange Act Rel. No. 44945 (Oct. 18, 2001), 76 SEC Docket 172, 177 (finding that respondent engaged in a plan of general distribution by selling ninety notes worth $1 million to more than forty-seven investors); *cf. Eagle Trim, Inc. v. Eagle-Picher Industries, Inc.*, 205 F. Supp. 2d 746 (E.D. Mich. 2002) (finding no plan of distribution for a single note given by the purchaser of assets to the seller in exchange for a loan to finance the purchase because plaintiffs did not allege that the note was offered to any other party, that there was any common trading, or that the note was acquired for speculation or investment purposes); *Singer v. Livoti,* 741 F. Supp. 1040 (S.D.N.Y. 1990) (finding no plan of distribution for a single note given to a single lender).

[57] *Deal v. Asset Mgmt. Group,* Fed. Sec. L. Rep. (CCH) ¶ 97,244 (N.D. Ill. 1992), 1992 U.S. Dist. LEXIS 13011, at *12-13 (stating that allegations of a plan of distribution involving an offering to at least six investors who were not linked in any way except as customers of the defendant firm gave rise to a reasonable inference that the investors were from a broad segment of the public).

[58] An additional factor supporting the finding of common trading is that the Gebharts sold the notes to individual investors. Courts have indicated that the sale of notes to individual investors suggests common trading due to "the purchasing individual's need for the protection of the securities laws." *See SEC v. Global Telecom Services, LLC,* 325 F. Supp. 2d 94, 114-15 (D. Conn. 2004) (stating that "where the notes are sold to individual investors rather than 'sophisticated institutions,' common trading has been found"); *see also Stoiber,* 161 F.3d at 751 (stating that respondent's sales to individual

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We reject the Gebharts' contention that no common trading existed because there was no secondary market in the notes, no client sold the notes to a third party, and the notes expressly prohibited resale without the issuer's permission. The notes do not expressly prohibit resale in any way, and the absence of secondary trading is not determinative. As discussed above, the sale of the notes to numerous individual investors, representing a broad segment of the public, establishes common trading.[59]

3. Reasonable Expectations of the Investing Public

Under the third *Reves* factor, we "must determine whether the promissory notes in question are reasonably perceived by the investing public as

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investors rather than "sophisticated institutions" suggested common trading).

[59] *See Goldsworthy*, 77 SEC Docket at 2036 (stating, where the notes did not prohibit secondary market trading, that the lack of proof of such trading was "not determinative," and finding that the sale of the notes to individual retail customers indicated common trading); *cf. Banco Espanol de Credito v. Sec. Pac. Nat'l Bank*, 973 F.2d 51, 55 (2d Cir. 1992) (finding no common trading in loan participations sold only to institutional investors because prohibition on resale without the express written permission of the issuer prevented loan participations from being sold to the general public and thus limited eligible buyers to those with the capacity to acquire information about the debtor).

securities."[60] "Whether notes are reasonably perceived as securities generally turns on whether they are reasonably viewed by purchasers as investments."[61] We "must look to a reasonable investor, not the specific individuals in question."[62] "When a note seller refers to notes as 'investments,' prospective purchasers may reasonably regard them as investments, absent contrary indications."[63] Here, the Gebharts characterized the notes as investments repeatedly. For example, the Gebharts wrote one prospective investor that they were "attach[ing] additional information about the trailer park investment," included the notes on another investor's "Suggested Investment Choices

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[60] *McNabb*, 298 F.3d at 1132. Courts "will consider instruments to be 'securities' on the basis of such public expectations." *Reves*, 494 U.S. at 66. This factor, therefore, is described as a "one-way ratchet." It allows notes that would not be deemed securities under the other three factors nonetheless to be treated as securities if the public has been led to believe they are, but does not allow notes which would otherwise be deemed securities to escape regulation. *Stoiber*, 161 F.3d at 751.

[61] *Stoiber*, 161 F.3d at 751.

[62] *McNabb*, 298 F.3d at 1132; *Wallenbrock*, 313 F.3d at 539. We note, however, that the third *Reves* factor "is closely related to the first factor – motivation for the transaction – and thus considerations discussed vis-a-vis that factor also come into play here." *Wallenbrock*, 313 F.3d at 539. We highlighted the noteholders' investment intent, as exemplified by their testimony that they viewed the notes as investments rather than real estate loans, in considering the first factor. *See supra* text following note 51.

[63] *McNabb*, 54 S.E.C. at 924 (citing *Reves*, 494 U.S. at 69 and *Stoiber*, 161 F.3d at 751).

and Considerations," and listed the notes on client statements entitled "Investment Portfolio." Gebhart also testified that he recommended the notes as "a type of investment vehicle," that he "indicated it would fit in [clients'] portfolio[s], based on their objectives," and that he "presented [the notes] as one alternative, as an investment strategy that might meet [clients'] goals." We find that prospective purchasers would reasonably view the notes as investments, and that therefore the investing public would reasonably perceive the notes as "securities."[64]

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[64] *See McNabb*, 54 S.E.C. at 924 (finding that investing public would reasonably consider the notes at issue to be investments where seller listed notes as "invested assets" on a noteholder's balance sheet and identified himself as a Registered Investment Advisor in correspondence pertaining to the notes); *Devine*, 78 SEC Docket at 2536-37 (finding that investors reasonably understood that the notes at issue were investments where seller testified that the loans were "investment money," used the term "to invest" in connection with making the loans, and detailed how his clients "invested . . . risk capital" in the notes). We reject the Gebharts' contention that the investing public would not consider the notes to be investments because the noteholders could only receive the stated fixed interest rate. *See Pollack v. Laidlaw Holdings, Inc.*, 27 F.3d 808, 814 (2d Cir. 1994) (finding that the fixed interest rate neither justified characterizing the noteholders' motivations as anything but investment nor altered the reasonable expectations of investors, pursuing a conservative investment strategy through registered securities professionals, that they were protected by the federal securities laws).

4. Need for Application of the Federal Securities Laws

The fourth and final factor in the *Reves* analysis is whether some factor, such as the existence of another regulatory scheme, significantly reduces the risk of the instrument, thereby rendering application of the federal securities laws unnecessary.[65] The Gebharts argue that California real estate law provides such an alternative regulatory scheme by regulating offers or sales of notes secured by trust deeds encumbering the same real property. The protections afforded by California law to lenders making real estate loans secured by trust deeds, however, do not render the protections of the federal securities laws unnecessary to individual investors investing in unsecured notes recommended and sold to them by securities professionals.[66]

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[65] *Reves*, 494 U.S. at 67.

[66] *See Pollack*, 27 F.3d at 814-15 (2d Cir. 1994) (finding that New York law governing collateralized mortgages did not reduce the risk of purportedly secured mortgage participations bought for passive, unsophisticated investors by their investment adviser because the "[i]nvocation of protections that might apply to the more usual mortgage loan distorts the character of these transactions" where the investors "held uncollateralized, speculative participations in mortgages and had not engaged in the usual process for extending such a loan"); *McNabb*, 54 S.E.C. at 924-25 (finding that "the protection of the federal securities laws should apply to the holder of the note secured by a deed of trust" despite respondent's argument that the note was "subject to regulation by the California Department of Real Estate"). We note that the cases on which *Reves* relied in discussing the

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We also reject the Gebharts' argument that a significant risk-reducing factor existed because the notes "were to be collateralized." Collateralization can be a risk-reducing factor,[67] but these notes were not actually collateralized. Most notes stated only that they would "ultimately" be secured by a deed of trust on property usually described only as "the property located in [city], [state]." These properties, moreover, turned out to be overencumbered. Furthermore, MHP did not record the deeds of trust. Fictitious collateralization does not reduce the risk of the instrument such that application of the federal securities laws is unnecessary.[68]

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fourth factor involved an alternative scheme of federal – not, as here, state – regulation. *McNabb*, 54 S.E.C. at 925 n.29 (citing *Reves*, 494 U.S. at 69); *see also* II LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 931 (3d ed. 1999) (stating that "the existence of a body of state regulation should be given little or no deference in determining whether an instrument is a security").

[67] *Bass v. Janney Montgomery Scott, Inc.*, 210 F.3d 577, 585 (6th Cir. 2000). We note that collateralization does not necessarily render the instrument a non-security.

[68] *Wallenbrock*, 313 F.3d at 539 (finding that no factor reduced the risk of notes purportedly secured by accounts receivable because the "so-called collateralization" was a fiction); *McNabb*, 54 S.E.C. at 924 (rejecting reduced risk argument with respect to a promissory note secured by a deed of trust because there was "no evidence that the deed of trust was recorded" and no "evidence as to the value of the property subject to the deed of trust"). We reject the Gebharts' reliance on *Singer*, 741 F. Supp. at 1050, where the court deemed the note "a note secured by a real estate mortgage" and therefore a non-security despite the failure to record the mortgage because the note, but for the fraud, would have been "one of many commonplace and

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We conclude, based on the above analysis, that the MHP notes constituted investments, and therefore securities, and thus fall outside the category of "notes secured by a mortgage on a home" considered non-securities.[69] This analysis also demonstrates that the notes should not be added to the list of notes recognized as non-securities.[70]

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successful conventional mortgage loan transactions." These notes were not commonplace conventional mortgage loan transactions.

[69] *Cf. William F. Wuerch,* 50 S.E.C. 811, 812 n.2 (1991) (finding that notes secured by an assignment of accounts receivable sold to the general public as an investment constituted securities, even though "short term notes secured by an assignment of accounts receivable" are deemed non-securities, because the Supreme Court, by stating that Congress' purpose in enacting the securities laws was to regulate investments, in whatever form they are made and by whatever name they are called, intended to exclude from the definition of a security only those notes issued in a purely commercial or consumer context) (emphasis in original) (citations omitted); *see also William Louis Morgan,* 51 S.E.C. 622, 626-27 (1993) (finding notes "securities" because respondent's notes "were sold to members of the general public as investments" and the Supreme Court intended to exclude only notes issued in a purely commercial or consumer context).

[70] *See Wallenbrock,* 313 F.3d at 540 (declining to add notes to the list of notes exempted from the federal securities laws "because the indicia of an investment are so strong").

IV.

Having found that the MHP notes are securities, we turn to an analysis of the Gebharts' liability under the securities laws and regulations for their involvement in offering and selling the notes.

A. Offer and Sale of Unregistered Securities

Sections 5(a) and 5(c) of the Securities Act provide that, unless a registration statement is in effect or an exemption applies, it shall be unlawful for any person, directly or indirectly, to offer or sell a security through the use of any means or instrumentality of transportation or communication in interstate commerce or of the mails.[71] A prima facie case for a violation of Section 5 is established by a showing that (1) no registration statement was in effect or filed as to the securities; (2) a person, directly or indirectly, sold or offered to sell the securities; and (3) the sale was made through the use of interstate facilities or the mails.[72] A showing of scienter is not required.[73]

As explained above, the MHP notes were securities. From 1997 to 2000, the Gebharts sold over

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[71] 15 U.S.C. §§ 77e(a)(1), 77e(c).

[72] *See SEC v. Continental Tobacco Co.*, 463 F.2d 137, 155 (5th Cir. 1972).

[73] *Swenson v. Engelstad*, 626 F.2d 421, 424 (5th Cir. 1980) ("The Securities Act of 1933 imposes strict liability on offerors and sellers of unregistered securities.").

$2 million of these securities to approximately forty-five clients, and stipulated that they made use of the mails in connection with those transactions. The Gebharts have also stipulated that no registration statement was in effect for the notes. Because NASD has made a prima facie case that the Gebharts violated Section 5, the burden shifts to the Gebharts to prove the availability of any exemptions.[74] They have not argued or shown that any exemption applies. Accordingly, we conclude that the Gebharts violated Section 5 of the Securities Act.[75]

B. NASD Conduct Rule 3040

NASD Conduct Rule 3040 provides that an associated person who intends to participate in a securities transaction outside the regular course or scope of employment must give prior written notice to his or her employer describing in detail the proposed transaction and stating whether he or she may receive selling compensation. If selling compensation

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[74] *See SEC v. Zubkis*, No. 97 Civ. 8086, 2000 U.S. Dist. LEXIS 1865, at *6 n.6 (S.D.N.Y. Feb. 23, 2000) (citing *SEC v. Ralston Purina Co.*, 346 U.S. 119, 126 (1953) and *Byrnes v. Faulkner, Dawkins and Sullivan*, 550 F.2d 1303, 1310-11 (2d Cir. 1977)).

[75] Further, because we have consistently held that a violation of a Commission or NASD rule or regulation is inconsistent with just and equitable principles of trade, we find that the Gebharts' sale of the unregistered MHP notes also constitutes a violation of NASD Conduct Rule 2110. *See Devine*, 78 SEC Docket at 2538 n.30; *Gluckman*, 54 S.E.C. at 185.

is to be received, the associated person may not engage in the transaction unless the employer gives its prior approval in writing. A showing of scienter is not required for a violation of Rule 3040.

The record establishes that the Gebharts violated NASD Rule 3040. MHP notes were not sold by MSC and did not appear on the firm's approved transaction list. Although the Gebharts provided some oral and written information on the MHP note program to MSC, it is undisputed that they never disclosed the details of their commission arrangement with Archer. Further, even if the Gebharts provided to MSC all the documentation they possessed about the program, the submission of those materials did not satisfy Rule 3040 with the specificity required. The most complete version of the CSG/MHP promotional materials contained in the record, although including information about successful park conversions, does not describe even in general terms the workings of the promissory note investment. Indeed, the materials were never intended to describe that aspect of the transaction: the brochures were created to serve as "promotional material that was used by MHP at trade shows" to distribute to park owners in order to promote park conversions.[76] The "pro forma" financial information gave projected cash flow figures for a sample park conversion, but offered no detailed information on the

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[76] Mounier testified that "mobile home park owners would have a convention, and we would set up a booth and obtain . . . interest from various park owners."

workings of the promissory note program beyond the anticipated purchase price of one park and the expected interest rate to be paid on the notes. The Gebharts did not provide information specific to any of the investments they actually sold to their clients. Moreover, even if the Gebharts had provided complete and explicit written notice of their intended involvement with the notes – which they did not – it is undisputed that the Gebharts never received written or even oral approval from MSC's compliance department to sell the notes.

The Gebharts assert that they reasonably believed they had MSC's authorization to proceed with the MHP note sales because they interpreted the silence of Poston and MSC's auditor as the firm's tacit conclusion that the MHP notes were not securities. Assumptions that the Gebharts may have drawn from MSC's silence, however, cannot substitute for the written permission clearly required by Rule 3040 and the relevant MSC policies, which unequivocally prohibit representatives from selling securities without prior, written permission from their firm.[77] The Gebharts argue that their violation of Rule 3040

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[77] The Gebharts also argue that they received further apparent approval for their MHP note sales when MSC's operations department faxed its approval to hold an MHP note in a 403(b) retirement account. However, this "approval" was limited to the discrete issue of how to process an investment of 403(b) funds into an MHP note, was not routed through any compliance personnel, and could not have been reasonably construed as blanket approval of the Gebharts' sales activity.

was unintentional, claiming that they believed they were in compliance with another NASD requirement, Rule 3030. Rule 3030, which applies to outside business activities not involving the sale of securities, requires written notice to the firm, but, unlike Rule 3040, does not require prior, written permission before associated persons participate in the activity. However, even assuming the Gebharts believed they were in compliance with Rule 3030,[78] and not subject to Rule 3040, a violation of Rule 3040 does not require a finding that it was done knowingly (or with any other degree of scienter); consequently, the Gebharts' belief is irrelevant. We therefore find that the Gebharts violated Rule 3040.[79]

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[78] The Gebharts were not charged with violating, and have not been (and are not here) found to have violated Rule 3030. However, we note, in response to the Gebharts' argument about Rule 3030, that their stated belief in their compliance with the rule is at odds with the rule's requirements. Rule 3030 requires "prompt written notice" of the activity in the form prescribed by the firm. The details of MSC's policy with respect to outside business activities evolved over time but always required, at the least, written notice of compensation received for the activity. It is undisputed that the Gebharts never disclosed in writing the compensation they expected to earn for their sales of MHP notes.

[79] As noted *supra* note 75, a violation of another Commission or NASD rule or regulation is inconsistent with just and equitable principles of trade. We therefore find that the Gebharts' sale of the MHP notes without prior, written approval from MSC also constitutes a violation of Conduct Rule 2110.

C. Fraudulent Misrepresentations and Omissions

Exchange Act Section 10(b), Exchange Act Rule 10b-5, and NASD Rule 2120 all prohibit fraudulent and deceptive acts and practices in connection with the offer, purchase, or sale of a security. Violations of these provisions may be established by a showing that persons acting with scienter misrepresented or omitted material facts in connection with securities transactions.[80] A fact is material if there is a substantial likelihood that a reasonable investor would have considered the fact important in making an investment decision, and disclosure of the omitted fact would have significantly altered the total mix of information available.[81] Scienter may be established by a showing of recklessness,[82] which involves an "'extreme departure from the standards of ordinary care, . . . which presents a danger of misleading buyers or sellers that is either known to the [actor] or

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[80] *Basic Inc. v. Levinson*, 485 U.S. 224, 239 n.17 (1988); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976).

[81] *Basic*, 485 U.S. at 231-32; *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976); *see also SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963) (stating that a fundamental purpose of the federal securities laws is "to substitute a philosophy of full disclosure for the philosophy of caveat emptor").

[82] *See, e.g., Robert M. Fuller*, Securities Act Rel. No. 8273 (Aug. 25, 2003), 80 SEC Docket 3539, 3546 n.20, *petition denied*, No. 03-1334 (D.C. Cir. 2004).

is so obvious that the actor must have been aware of it.' "[83]

The Gebharts offered and sold over $2 million in MHP notes to their clients. In doing so, the Gebharts told their clients that investments in the notes would be secured because second deeds of trust on the properties purchased with client funds would be recorded, and because in the event of a default on the MHP notes, clients could recover their investments by foreclosing on the properties and liquidating the collateral. These representations were false: second deeds of trust purportedly securing the MHP notes were not recorded, and, had they been recorded, the properties would have been substantially over-encumbered. MHP's only purported asset pending recordation of the deeds, a $100,000 deed of trust on Eastern Trailer Park, apparently never existed. Moreover, the Gebharts failed to disclose to clients that, in making these representations and recommending the MHP notes, the Gebharts relied upon the vague and conclusory statements made in the marketing materials used by the issuer to induce trailer park owners to convert to tenant ownership, upon the bald representations of Archer (who stood to gain substantial commissions on each sale), upon site

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[83] *The Rockies Fund, Inc. v. SEC*, No. 04-1255 (D.C. Cir. Nov. 15, 2005), 2005 U.S. App. LEXIS 24521, at *12 (citing *Steadman v. SEC*, 967 F.2d 636, 641-42 (D.C. Cir. 1992) (quoting *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1044-45 (7th Cir. 1977))).

visits the Gebharts made to two parks that confirmed nothing but proof of the parks' existence,[84] and upon the absence of complaints from the customers to whom they had already sold notes. The Gebharts never disclosed to clients that they performed no meaningful investigation of the notes or their issuer, nor did they disclose to clients that they did not understand the details of the transactions they were recommending.[85] These misrepresentations and omissions, which bore directly on the level of risk involved with an investment in MHP notes, were material. We therefore conclude that the Gebharts misrepresented and omitted material facts in connection with the offer and sale of securities.[86]

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[84] It is unclear what information the Gebharts hoped to, or did, find on these two site visits that would bear on the viability of the promissory notes or their issuer.

[85] As noted *supra* note 11, the Gebharts knew nothing about the holders of the first deeds of trust secured by the mobile home parks nor whether the properties were encumbered by any other liens. Moreover, the Gebharts did not know, or attempt to determine, into which bank accounts client money went, how cash flowed through MHP, or whether any of the park conversions that their clients' notes purportedly financed actually happened. For example, the Gebharts never knew or asked about whether funds would be placed in escrow. When Gebhart was asked at the hearing about his knowledge of any escrow arrangement, he replied, "What is an escrow account, ma'am?"

[86] Misrepresentations and omissions are also inconsistent with just and equitable principles of trade and violate NASD Conduct Rule 2110. *Robert Tretiak*, Exchange Act Rel. No. 47534 (Mar. 19, 2003), 79 SEC Docket 3166, 3180.

We also find that, in making these material misrepresentations and omissions, the Gebharts acted recklessly and, therefore, with the requisite scienter. Securities professionals have a duty to investigate offerings before presenting and selling them to clients,[87] and must have a reasonable basis for recommending that customers purchase those securities; they may not "deliberately ignore that which [they have] a duty to know and recklessly state facts about matters of which [they are] ignorant."[88] The Gebharts failed to discharge this duty to their clients because, despite numerous warning signs or "red flags" that demonstrated a need for a thorough investigation, the Gebharts made no meaningful effort to perform one before recommending MHP notes to their clients.

CSG and MHP were small, relatively unknown entities engaged in a business with which the Gebharts had no experience; MHP came into existence only a few months before the Gebharts began selling the notes it issued. Furthermore, Archer paid the Gebharts their commissions with personal checks and told the Gebharts that they were not to contact

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[87] *Richard H. Morrow*, 53 S.E.C. 772, 779 (1998) (citing *Hanly v. SEC*, 415 F.2d 589, 595-96 (2d Cir. 1969)).

[88] *Hanly*, 415 F.2d at 596; *see also Jay Houston Meadows*, 52 S.E.C. 778, 785 (1996) (holding that salesman of registered broker-dealer "had an obligation to investigate and verify consistently optimistic assertions before repeating them to others," especially in light of "the several suspicious circumstances that were present").

CSG or MHP directly, and that all communication with the companies must be channeled through Archer. The Gebharts had no access either to the books and records of the companies or to the principals or even office staff; Gebhart testified that although he contacted the offices of MHP a few times, the staff "kept referring [the Gebharts] back to Jack Archer."[89]

Moreover, the form of the MHP notes themselves should have raised questions: the notes were vaguely worded and offered no description of the property supposedly serving as collateral other than "the property located in [city], [state]." The notes also stated that MHP itself owned but one asset, worth only $100,000, and that this would be the sole source of collateral for the notes until they were eventually secured by recorded deeds of trust. At a minimum, this feature of the notes should have alerted the Gebharts to the risk of loss when more than $100,000 in notes were sold. In addition, the interest rates offered by the MHP notes, combined with the commissions that the Gebharts knew MHP was paying to them and to Archer, added up to a substantial payout (up to 28% or more for new note purchases);[90]

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[89] *Cf. Meadows*, 52 S.E.C. at 785 (finding that salesman of a registered broker-dealer made misrepresentations that were reckless, based in part on a denial of unrestricted access to the issuer's records even though salesman claimed "not to have been troubled by this development").

[90] The Gebharts did not know that MHP paid Archer 10% on each new note sale; they knew only that they shared 50% of

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nevertheless, the Gebharts made no effort to determine whether MHP would be able to afford the cost of servicing the notes.[91]

Notwithstanding these facts, the Gebharts performed virtually no investigation of the MHP notes or their issuer before recommending the MHP notes as essentially risk-free to clients based on the recordation of deeds of trust for the notes and the sufficiency of the collateral. The Gebharts made no effort to ensure that the deeds of trust purportedly securing the MHP notes were recorded; they were never provided, nor did they request, a copy of a deed of trust that had been recorded. The Gebharts also made no effort to confirm that the parks contained sufficient equity to discharge the note obligations. Although the Gebharts "were of the understanding" that generally the parks were not to be encumbered with debt totaling more than 45 to 55 percent of the

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Archer's commissions. Accordingly, the Gebharts may have believed that MHP paid Archer as much as 12-14% in commissions for new note sales, given that they earned 6-7%, resulting in a total 32% payout by MHP for new notes.

[91] The Gebharts presented testimony from a witness they offered as an expert on real estate transactions; this witness asserted that the interest rates combined with broker commissions payable on "second trust deed hard money loan[s]" in the late 1990s were between 20 and 33 percent. We note that, even if the MHP notes could be characterized as "second trust deed hard money loans," a return this substantial on its face, even if common for this type of note, should still have prompted the Gebharts to confirm that MHP could afford the cost of servicing the notes.

property's value,[92] the Gebharts never sought or examined any information or documents that normally help to confirm the value of real property, such as an appraisal, escrow instructions, or title report. Furthermore, the Gebharts did not keep track of the number or amount of investments their own clients made into each park and did not know or ask how many of Archer's clients were investing in those same parks. The Gebharts also never investigated the nature or extent of the first trust deeds against the parks, nor whether any other liens existed against the properties purportedly serving as collateral for the notes.[93]

As indicated, the Gebharts do not deny making the misrepresentations and omissions that are the basis for this aspect of the case, but claim that they did so without the scienter necessary to support a finding of fraud. The Gebharts claim that they, like their customers, were victims of the fraud of others. According to the Gebharts, they offered and sold the

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[92] It is unclear whether even this limited understanding, which D. Gebhart testified she gathered from representations made by Archer, was accurate: Archer testified in a civil deposition that he did not recall ever telling the Gebharts that the loan-to-value ratio on the parks would be in that range; his conversations with Scovie indicated only that the ratio would be less than 85%. Of course, ultimately the Gebharts learned that the loan-tovalue ratio of these properties actually exceeded 100%.

[93] This information would have been important because holders of notes recorded prior in time have priority over later lienholders in the event of default.

notes in "good faith," which they assert is supported by the finding of NASD's Hearing Panel, which heard their testimony and concluded that the Gebharts

> truly believed that they had fulfilled their responsibilities to assure that MHP and CSG were appropriate investments, based on (i) the information they received from Mr. Archer, whom they believed to be reliable; (ii) the information they gathered about mobile home conversions from [the U.S. Department of Housing and Urban Development ("HUD")] and other municipal and state agencies; (iii) their one-year personal payment history with the MHP promissory note; and (iv) Mutual Service's lack of response to the information concerning the mobile home conversion provided to it.[94]

However, we conclude that the factors identified by the hearing panel do not support a finding of good faith. First, the information the Gebharts received from Archer, no matter how reliable they deemed him to be, was inadequate to provide a reasonable basis

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[94] The Hearing Panel found that the Gebharts acted with negligence, but not with the scienter necessary to find fraud, in offering and selling the notes. In finding recklessness rather than negligence, NASD's National Adjudicatory Council (the "NAC") concluded that the four factors identified by the Hearing Panel provided "scant reasons for the Gebharts to believe they had fulfilled their duty to investigate." The NAC also noted that the evidence established that the Gebharts acted with "more than just empty-headedness," and engaged in an "extreme departure from the standards of ordinary care."

for recommending the notes to others. We have long held that "a salesman may not satisfy his duty to investigate the securities he recommends by relying 'blindly' on information supplied by persons connected with the issuer."[95] Second, contrary to the Hearing Panel's finding, the record does not support a finding that the Gebharts sought information from HUD or any other government agencies about mobile home conversion programs or financing therefor.[96] Even if it did, general information about mobile home park conversions would have shed no light on the specific conditions under which the MHP note program was being operated. Third, the personal investment the Gebharts made despite their own failure to investigate the notes cannot render reasonable the Gebharts' actions in light of the numerous red flags in this case.[97] Finally, MSC's failure to respond to the

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[95] *Morrow*, 53 S.E.C. at 779-80 (citing *Hanly v. SEC*, 415 F.2d 589, 597 (2d Cir. 1969)); *see also Sorrell v. SEC*, 679 F.2d 1323, 1327 (9th Cir. 1982) (holding that reliance on assurances from attorney and another broker does not excuse broker's own lack of investigation).

[96] D. Gebhart testified in one instance that the Gebharts "had found out about the HUD housing," but it is unclear whether she is simply referring to information Archer gave them or to some independent research the Gebharts conducted. Because the Gebharts make no mention of an investigation of the HUD financing elsewhere in these proceedings, we decline to find that the Gebharts investigated the role of government entities in CSG's or MHP's activities.

[97] *See John R. Brick*, 46 S.E.C. 43, 49 n.16 (1975) ("Brick stresses the fact that he bought the stock himself. Moreover, he recommended Thorne [stock] to his father-in-law. But his

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Gebharts' communications about the MHP note program does not excuse their own failure to make appropriate inquiries before recommending the notes.[98] Put simply, even an "honest belief in an issuer's prospects does not in itself give [one] a reasonable basis for recommending the [investment] to others."[99]

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willingness to gamble with his own money and with that of his father-in-law did not give him a license to make unfounded recommendations to clients."); *see also Dane S. Faber*, Exchange Act Rel. No. 49216 (Feb. 10, 2004), 82 SEC Docket 530, 543 ("A registered representative's willingness to speculate with his own funds despite his knowledge of adverse financial information does not excuse his failure to disclose material information to his customer.") (citing *Richard J. Buck & Co.*, 43 S.E.C. 998, 1008 (1968), *aff'd sub nom. Hanly v. SEC*, 415 F.2d 589 (2d Cir. 1969)). We further note that one year of success, by itself, cannot form the basis for a prediction of future success; for example, NASD Rule 2210, like many Commission rules, has long prohibited securities sellers from predicting or projecting performance and from implying that past performance will recur.

[98] *See Donald T. Sheldon*, 51 S.E.C. 59, 88 n.130 (1992) (stating that duties owed by securities professional to customers are "not abridged by a failure on the part of his supervisors"), *aff'd*, 45 F.3d 1515 (11th Cir. 1995); *Justine Susan Fischer*, 53 S.E.C. 734, 741 n.4 (1998) (holding that "[a] broker has responsibility for his or her own actions and cannot blame others for [his or] her own failings"). For the same reason, we do not credit the Gebharts' similar argument that the bank holding the custodial accounts of some clients should shoulder the blame, and thereby exonerate the Gebharts, because the bank did not ensure the trust deeds securing the MHP notes were recorded.

[99] *Sheldon*, 51 S.E.C. at 70 n.41 (citing *Gilbert F. Tuffli*, 46 S.E.C. 401, 405 (1976)); *see also James E. Cavallo*, 49 S.E.C.

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In sum, we find that the record does not support a finding of good faith. We conclude, as discussed above, that the actions of the Gebharts in recommending the notes, based on material misrepresentations and omissions of material fact, were done with recklessness, in violation of the antifraud provisions.

V.

Under Exchange Act Section 19(e)(2), we may reduce or set aside sanctions imposed by NASD if we find, having due regard for the public interest and the protection of investors, that the sanctions are excessive or oppressive or impose an unnecessary burden on competition.[100]

NASD Sanction Guidelines recommend imposition of a fine between $5,000 and $50,000 for private securities transactions and a one-year suspension or a bar where, as here, the sales exceeded $1,000,000.[101]

1099, 1102 (1989), petition denied, 993 F.2d 913 (D.C. Cir. 1993) (Table) ("A salesman's honest belief in an issuer's prospects does not warrant his making exaggerated and unfounded representations and predictions to others.").

[100] 15 U.S.C. § 78s(e)(2). The Gebharts do not claim, and the record does not show, that NASD's action imposed an undue burden on competition.

[101] NASD Special Notice to Members 03-65 (Oct. 2003). The guideline provides that the first step is to assess the extent of the selling away, including the dollar amount of sales, the number of customers, and the length of time over which the selling away occurred. The second step is to consider the other factors described in the principal considerations for the

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The Guidelines recommend a fine between $2,500 and $50,000 for selling unregistered securities and, in egregious cases, a suspension of up to two years or a bar.[102] For reckless or intentional misrepresentations or omissions of material fact, NASD Sanction Guidelines recommend a fine between $10,000 and $100,000 and a suspension between ten business days and two years; in egregious cases, the Guidelines recommend a bar.[103] Using these Guidelines, NASD found that Gebhart's sale of unregistered securities and private securities transactions supported a bar; NASD also found that a bar was warranted for Gebhart's fraudulent sales of securities. D. Gebhart was sanctioned with two one-year suspensions for those same violations and assessed a total fine of $15,000.[104]

We have held repeatedly that engaging in private securities transactions and selling unregistered securities are both serious violations.[105] NASD Rule 3040 protects investors from unsupervised sales as

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guideline and the general principles application to all guidelines. The presence of one or more aggravating or mitigating factors may increase or decrease sanctions.

[102] NASD Sanction Guidelines 30 (2001 ed.).

[103] NASD Sanction Guidelines 96 (2001 ed.).

[104] Although NASD found that D. Gebhart "played a less substantial role," we believe that the record would support a finding that D. Gebhart's responsibility for these violations was equivalent to that of Gebhart.

[105] *See, e.g., Gerald James Stoiber*, 53 S.E.C. 171, 180 (1997); *Excel Financial, Inc.*, 53 S.E.C. 303, 313 (1997).

well as securities firms from liability and loss resulting from such sales.[106] Its violation deprives investors of protections they have a right to expect, such as a firm's oversight, due diligence, and supervision.[107] Similarly, the keystone of the Securities Act, Section 5, serves to protect the public in the offer and sale of new securities issues;[108] its registration provisions set forth basic requirements for the protection of investors.[109] The Gebharts' misconduct illustrates the potential for harm to public investors through unsupervised securities transactions and the sale of unregistered securities, and warrants substantial sanctions.[110]

The Gebharts, in addition to engaging in private securities transactions and selling unregistered securities, also engaged in fraud. "[C]onduct that violate[s] the antifraud provisions of the federal securities laws is especially serious and subject to the

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[106] *Chris Dinh Hartley*, Exchange Act Rel. No. 50031 (July 16, 2004), 83 SEC Docket 1239, 1247; *Gluckman*, 54 S.E.C. at 192.

[107] *Hartley*, 83 SEC Docket at 1247-48; *Ronald W. Gibbs*, 52 S.E.C. 358, 365 (1995).

[108] *First Heritage Investment Co.*, 51 S.E.C. 953, 959 (1994).

[109] *Independent Securities Corporation*, 47 S.E.C. 780, 784 (1982).

[110] *See, e.g., Anthony H. Barkate*, Exchange Act Rel. No. 49542 (Apr. 8, 2004), 82 SEC Docket 2443, 2455 (upholding bar for violating Rule 3040), *aff'd*, 125 Fed. Appx. 892 (9th Cir. 2005).

severest of sanctions under the securities laws."[111] Here, the Gebharts offered and sold over $2 million worth of notes to their clients while representing falsely that the notes would be secured by deeds of trust on real property that was more than adequate to cover the amounts the clients were investing. The notes, in fact, were largely unsecured, and the collateral proved seriously inadequate to cover the sums invested.

There were also several aggravating factors present in this case that NASD identified. Among other things, NASD found that the Gebharts attempted to create the impression that their member firm approved their sale of the notes by writing to customers of the firm on letterhead stating "Securities offered by Mutual Service Corporation."[112] We further note that, as NASD found, the Gebharts' misconduct also resulted in significant monetary gain for themselves.

We reject the Gebharts' contention that the sanctions are excessive because "they did all they could do to avoid the risk of engaging in the sale of unregistered securities." The Gebharts argue that

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[111] *Marshall E. Melton*, Investment Advisers Act Rel. No. 2151 (July 25, 2003), 80 SEC Docket 2812, 2825.

[112] *Cf. Barkate*, 82 SEC Docket at 2454-55 (upholding bar where respondent created the impression that his employer sanctioned the sale of the instruments, sold instruments directly to customers of his employer, engaged in the misconduct over a nine-month period, and generated $6.8 million in sales).

they notified their firm in advance of their sales of the MHP notes and that "[b]oth MONY and MSC determined the legal status of the notes as being non-securities." This latter assertion is unsupported by the record and, for that reason, we do not credit it with any mitigative effect. The Gebharts' interpretation of Poston's silence as a tacit determination of the notes as non-securities cannot substitute for express approval by the firm (or a decision by the firm that approval is not required) and does nothing to excuse their violation. Further, the Gebharts' own judgment that the MHP notes were not securities, based on Archer's assertion that MONY "did not see a problem," does not diminish their failure to provide written notice to their firm informing it of their activities and allowing it to make its own determination on this issue.[113]

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[113] *Joseph J. Vastano, Jr.*, Exchange Act Rel. No. 50219 (Aug. 19, 2004), 83 SEC Docket 2015, 2023 (rejecting salesman's argument that it was a mitigating factor that his supervisor told him the product was not a security and finding that salesman's "belief that the [product] was not a security or the assertions of others that it was not, are not relevant in determining whether the [products] were securities or whether he should have given [his firm] written notice to permit [it] to make an independent determination of that issue."), *reconsid. denied*, Exchange Act Rel. No. 50691 (Nov. 18, 2004), 84 SEC Docket 426; *see also Gilbert M. Hair*, 51 S.E.C. 374, 377 (1993) (rejecting respondent's reliance on "his own judgment and that of the issuer" for his belief that the notes were not securities). We also point out that the Gebharts' reliance on Archer's confidence that the notes were not securities is further undermined by the fact that, at the same time, Archer encouraged the Gebharts to solicit MSC's

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The Gebharts cite their spotless disciplinary history, contrition,[114] and cooperation with NASD's investigation, all of which we have considered, as did NASD, in mitigation. The Gebharts also note that they have made substantial efforts to assist their customers in recovering their funds by filing a petition for involuntary bankruptcy against MHP and suing their own insurance carrier. Although we recognize that the Gebharts' efforts resulted in significant recoveries for their customers, we note that the Gebharts had an interest in recovering their own funds and, presumably, avoiding personal liability for their actions.[115] In sum, we agree with NASD that the

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permission to sell the notes notwithstanding MONY's apparent approval.

[114] We note that the mitigative effect of the Gebharts' contrition is diminished by their argument that the MHP note program would have been successful absent Scovie's fraud and that other actors failed to fulfill their obligations and thus allowed the fraud to escape detection. *See Vastano,* 83 SEC Docket at 2025 (finding that respondent's argument that the instrument would have been successful absent the fraud had no impact on his obligation to give notice to his firm); *Mike K. Lulla,* 51 S.E.C. 1036, 1040 (1994) (upholding bar because "the fact that others also might have been remiss in their duties does not mitigate [respondent's] responsibility").

[115] As noted *supra* note 32, the Gebharts have not provided evidence of expenses they incurred, or recoveries they declined, in their efforts to recoup customer losses. Although efforts to help defrauded customers recover their losses are acknowledged and encouraged, those efforts do not always justify a reduction in sanctions. *See Hartley,* 83 SEC Docket at 1247 ("We do not consider that Hartley is deserving of a reduction in sanctions because his clients may be able to recover some of their losses.").

mitigating factors identified by the Gebharts do not outweigh the aggravating circumstances present in this case.

Under these circumstances, where the Gebharts, without notice to or approval from their firm, sold over $2 million in unregistered securities to dozens of investors over the course of more than three years based on fraudulent misrepresentations and omissions, we find that a bar is manifestly warranted against Gebhart. Similarly, on this record, we find that the suspension and fine imposed on D. Gebhart are well within the range of sanctions appropriate for the selling away of unregistered securities involving fraud. We therefore find that the sanctions NASD imposed against the Gebharts are neither excessive or oppressive, and we sustain NASD's findings of violation and imposition of sanctions.[116]

An appropriate order will issue.

By the Commission (Chairman COX and Commissioners ATKINS, CAMPOS, and NAZARETH); Commissioner GLASSMAN not participating.

Nancy M. Morris
Secretary

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[116] We have considered all of the arguments of the parties. We reject or sustain them to the extent that they are inconsistent or in accord with the views expressed in this opinion.

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 53136/January 18, 2006

Admin. Proc. File No. 3-11953

In the Matter of the Application of

ALVIN W. GEBHART, JR.
and
DONNA T. GEBHART

c/o Charles F. Goria
Goria & Weber
7863 La Mesa Blvd. Suite 201
La Mesa, CA 91941

For Review of Disciplinary Action Taken by NASD

ORDER SUSTAINING DISCIPLINARY ACTION

On the basis of the Commission's opinion issued this day, it is

ORDERED that the disciplinary action by NASD against Alvin W. Gebhart, Jr. and Donna T. Gebhart, and NASD's assessment of costs be, and they hereby are, sustained.

By the Commission.

Nancy M. Morris
Secretary

BEFORE THE NATIONAL
ADJUDICATORY COUNCIL

In the Matter of Department of Enforcement, Complainant, vs. Alvin W. Gebhart, Jr. Fallbrook, Ca, and Donna T. Gebhart, Fallbrook, Ca, Respondents.	DECISION Complaint No. C02020057 Dated: May 24, 2005

Hearing Panel found that respondents engaged in private sales of unregistered securities and made negligent omissions of material fact. *Held*, findings affirmed in part, modified in part, and sanctions modified.

APPEARANCES

For Complainant: Sylvia M. Scott, Esq., Leo F. Orenstein, Esq., NASD Department of Enforcement.

For Respondents: John H. L'Estrange, Jr., Esq., Charles F. Goria, Esq.

DECISION

Pursuant to Procedural Rule 9312(a), the National Adjudicatory Council ("NAC") Review Subcommittee ("Review Subcommittee") called this matter to review the findings in, and the sanctions imposed by, a February 9, 2004 NASD Hearing Panel decision. The Hearing Panel found that, from January 1997 to February 2000, Alvin W. Gebhart, Jr. ("Alvin Gebhart") and Donna T. Gebhart ("Donna Gebhart") (together, "the Gebharts" or "respondents") offered and sold unregistered securities, through negligent material omissions, without providing written notice to, or obtaining prior approval from, their employer. The Hearing Panel dismissed, however, the Department of Enforcement's ("Enforcement") allegations that respondents fraudulently omitted material information in connection with the offer and sale of securities. Finding that Alvin Gebhart was primarily responsible for the violations, the Hearing Panel: (1) suspended Alvin Gebhart for one year in all capacities and fined him $100,000; and (2) suspended Donna Gebhart for seven months in her capacity as a general securities representative and fined her $7,500. The Hearing Panel also ordered respondents to pay costs of $5,141.21, jointly and severally.

We affirm the Hearing Panel's findings that respondents offered and sold unregistered securities that were not exempt from registration without providing written notice to, or obtaining prior approval from, their firm. We modify, however, the Hearing Panel's findings that respondents made negligent

omissions and instead find that they recklessly omitted material facts. We also increase the sanctions imposed by the Hearing Panel. We bar Alvin Gebhart from associating with any member firm in all capacities. In light of the bar, we vacate the $100,000 fine that the Hearing Panel imposed on him. As for Donna Gebhart, we increase the fine to $15,000, increase her suspension to one year, and order her to requalify by examination as a condition of continued employment in the securities industry.

I. Background

Alvin Gebhart first became registered as an investment company products/variable contracts representative in May 1983. From on or about January 30, 1996, through August 11, 2000, Alvin Gebhart was associated with Mutual Service Corporation ("MSC") as an investment company products/variable contracts representative. On December 10, 1997, he also became associated with MSC as a general securities representative. Prior to joining MSC, Alvin Gebhart was associated with MONY Securities Corporation ("MONY") as an investment company products/variable contracts representative. Alvin Gebhart is currently registered with another member firm.

Donna Gebhart was associated with MSC as an investment company products/variable contracts representative from on or about February 14, 1996, through August 11, 2000. On April 27, 1998, she became registered with MSC as a general securities

representative. Donna Gebhart is currently registered with another member firm. Alvin and Donna Gebhart, husband and wife, worked in the same office for some of the relevant time period. From April 15, 1997, the Gebharts conducted business under the name Gebhart & Associates, Inc., which has been a registered investment adviser since June 3, 1998.

II. Factual Findings

A. The MHP Promissory Notes

This matter involves the sale by respondents of promissory notes issued by MHP Conversions, LLC ("MHP"), a California limited liability company. MHP was formed in 1997 to facilitate "resident acquisitions" services offered by Community Service Group ("CSG"), which managed sales of mobile home parks from their owners to their residents. CSG's acquisition services involved setting up a separate, non-profit entity that would acquire a mobile home park and selling shares in the non-profit entity to the park's residents. The residents' purchase of shares was financed by a number of sources, including private financings, the State of California, local municipalities, and the U.S. Department of Housing and Urban Development ("HUD").

MHP was formed to simplify the financing operations for CSG's resident acquisitions services.[1] MHP

[1] MHP's owners, and their respective interests, were as follows: (i) Eivocs, Inc., 50 percent, which was owned by James

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obtained financing to purchase each mobile home park through the issuance of promissory notes. Holders of promissory notes would be paid in full when the notes matured or when CSG sold the mobile home park to its residents, whichever occurred earlier. During the relevant period, MHP (and CSG, prior to MHP's formation) issued promissory notes (the "MHP notes") that were one year in duration and paid interest rates between 14 and 19 percent. Each promissory note stated it would "ultimately" be secured by recorded deeds of trust on a property, the description of which usually contained nothing more than a city and state of location. The MHP notes further provided that, until such deeds of trust were recorded, "the sole asset" of MHP was a $100,000 deed of trust on a property known as Eastern Trailer Park, in El Cajon, California. No registration statement for the MHP notes was filed or in effect with the SEC at any time.

B. Archer Introduces Alvin Gebhart to the MHP Notes Program

From February 1994 to January 1996, Alvin Gebhart was associated with MONY, where his business consisted primarily of selling insurance, mutual funds, and variable annuities. While at MONY, Alvin

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Scovie ("Scovie") and his wife; and (ii) David W. Mounier, Inc., 50 percent, which was owned by David Mounier ("Mounier") and his wife. CSG was owned by Scovie.

Gebhart met John T. Archer ("Archer"), a MONY registered representative. Over the course of a couple of conversations in 1995 and early 1996, Archer introduced Alvin Gebhart to CSG's resident acquisitions program and inquired whether Alvin Gebhart had clients who might be interested in investing in that program. Subsequently, Alvin Gebhart referred three of his clients to Archer and was "most likely" present at Archer's presentations to them. Alvin Gebhart testified that, at that point, he did not "feel any danger" with the MHP notes because Archer had been marketing the program for years, he had no reason to doubt that MONY had approved Archer's sales, and his clients would be dealing only with Archer and could make their own decisions.

C. Alvin and Donna Gebhart Join MSC

Dissatisfied with his compensation and the nature of his assigned work, Alvin Gebhart left MONY in late January 1996, became registered with MSC as an investment company products/variable contracts representative, and opened an MSC non-Office of Supervisory Jurisdiction branch office located in Rancho Bernardo, California.[2] When he first opened this branch office, Alvin Gebhart sold only variable

[2] MSC's home office principals in Florida supervised Alvin Gebhart's branch office, one of approximately 300 MSC branch offices in 1996. Alvin Gebhart testified that MSC sent him a compliance manual and a "marketing book," but did not otherwise offer assistance to help set up his branch office.

annuities, insurance products, and mutual funds. At around the same time, Donna Gebhart decided to join her husband in his business. On February 14, 1996, Donna Gebhart became registered with MSC as an investment company products/variable contracts representative.

As part of their application to join MSC, the Gebharts each completed an outside business activities questionnaire. Respondents represented that Alvin Gebhart was engaged in insurance sales, medical benefit planning services, and financial planning, but that they were not otherwise engaged in any outside business activities.

On February 16, 1996, Alvin Gebhart acknowledged receiving and reading the compliance section of MSC's policies and procedures manual. Alvin Gebhart testified that he "scanned" the compliance manual and followed it "[a]s best I could." The manual contained the following instruction concerning private securities transactions: "All Representatives must notify MSC in advance, in writing, of their intent to 'engage in private securities transactions outside the regular course or scope of their association or employment.' No Representative is allowed to participate in such transactions without MSC's consent and written approval." The manual also explained that MSC conducted a due diligence investigation before approving private securities transactions, and that, if a product were approved, all commissions would flow through MSC. In addition, the manual provided this cautionary advice:

> The failure of Representatives to notify their member firms about proposed private security transactions raises a number of serious problems. The securities or investments which Representatives believe to be exempt from registration may, in fact, not be exempt, and private transactions in such instruments may cause violations of . . . securities laws and . . . NASD [ ] Rules. . . . Notification to the employer serves to protect Representatives in matters in which they may not be as well informed.

On September 9 and 10, 1996, respondents acknowledged receiving and reading an updated MSC manual, which provided more detailed procedures concerning outside business activities and private securities transactions. Citing NASD Conduct Rule 3040, the amended manual explained that, for private securities transactions, "a Representative must obtain prior approval in writing" and that "[m]ere disclosure . . . is *not* sufficient." The amended manual also explained that "[o]ffering any security not listed in MSC's Product Notebook, specifically including so-called 'exempt' or alleged non-securities 'deals,"D' required advance written approval by MSC.[3]

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[3] Citing only the introductory paragraph of the section addressing ""outside business activities and private securities transactions," the Hearing Panel found that the amended manual did not clearly identify which types of outside business activities required affirmative written approval from MSC. In our view, however, when the cited passage is read in the context

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D. The Gebharts' Decision to Sell MHP Notes and Their Communications with MSC Compliance Director Michael Poston

Between January 10 and October 3, 1996, the three clients whom Alvin Gebhart referred to Archer ultimately invested a total of $65,000 in MHP notes. For these investments, Archer paid Alvin Gebhart finder's fees, using personal checks. On October 3, 1996, the Gebharts themselves invested $7,000 in an MHP note.

On or about October 23, 1996, Archer met with the Gebharts and asked if they had more clients who would be interested in investing in MHP notes. During this meeting, the Gebharts learned a little more about the mobile home park conversion process and obtained literature describing the program. According to the Gebharts, Archer told them the notes were secured by second deeds of trust, and that "there was always at least 45% equity in the park above the 1st and the 2nd deeds of trust." Archer also said that CSG's officers worked with HUD, FHA, and Banc One to obtain financing for the individual purchasers of the mobile home parks. In addition, Archer represented that the MHP notes were not securities but, instead, a "fixed-income product" and "real estate second deeds of trust," and that, to "avoid any possibility of securities issues," there would always be fewer

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of the entire section it introduces, MSC's instructions clearly explain that private securities transactions require written approval.

than 10 investors in each park. Finally, Archer said that MONY's Compliance Department had approved his sales of MHP notes. Unbeknownst to the Gebharts, however, Archer had never sought nor received written approval from MONY to participate in these types of transactions.

Donna Gebhart explained that she and her husband liked that the MHP notes had a fixed rate of interest, were short-term, that Archer had sold them for years, and that the financing for park residents came from "large entities." But apart from the information that Archer gave them, the Gebharts neither knew nor sought further details. Alvin Gebhart testified that, at that time, he had no reason to distrust Archer. Alvin Gebhart's manager at MONY, Bill Freiss, had recruited Archer and spoke highly of him. In addition, Alvin Gebhart assumed the MHP investments had been successful because none of his three clients who had already invested had complained.

Archer advised the Gebharts to contact MSC's Compliance Department to see if they could sell the product. On October 23, 1996, Alvin Gebhart called MSC's Compliance Department to discuss the CSG program and spoke with Michael Poston ("Poston"), MSC's Compliance Director, who had approximately 800 representatives under his supervision. The Gebharts and Poston recalled this conversation somewhat differently. Alvin Gebhart testified that he described the CSG program, explained that he would be splitting commissions with Archer, and answered "a lot" of questions from Poston. He further testified that

Poston said the CSG program "sounded like a good idea" and asked the Gebharts to send him more information. Alvin Gebhart admitted, however, that he did not inform Poston about his three clients who had already invested. Donna Gebhart, who heard her husband talking on the phone, testified that Alvin Gebhart informed Poston that he wanted to offer MHP notes to his clients. Poston, in contrast, did not understand that Alvin Gebhart was requesting permission to sell anything. Instead, he thought Alvin Gebhart was calling to see if MSC "had a position" on trailer park programs and to ask about MSC's procedures should he want to offer the notes to his clients. Poston testified that he told Alvin Gebhart he would need to submit a detailed letter describing the program and his proposed role. Nevertheless, Poston testified that Alvin Gebhart said he had not sold the products to anyone, which Poston took "as an indication that [Alvin Gebhart] . . . had no interest in it." Poston stated that the call lasted five minutes.[4]

Subsequently, Alvin Gebhart sent to Poston a letter enclosing written materials concerning the CSG program and asking Poston to "review [the] information and please let me know what you think of it." The materials included a description of the park conversion strategy, "pro forma" financial documents,

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[4] While the Hearing Panel did not indicate whose version of the conversation was credible, it concluded that Alvin Gebhart provided Poston with verbal notice of the mobile home park program.

an investment summary for one specific park conversion project, examples of past and pending park conversions, and newspaper clippings describing CSG's involvement in past park conversions.[5] Poston testified that he "didn't know what to make of [the letter]" and did not interpret it as a written request for approval to sell MHP notes. Poston did not contact Gebhart again, and it is undisputed that MSC did not provide the Gebharts with written approval to sell the MHP notes. Alvin Gebhart allegedly assumed that Poston's silence was tantamount to MSC's approval. Alvin Gebhart testified that the MHP notes were "not a security that I knew about," and respondents both claimed they assumed that MSC would have contacted them if there was a problem.

E. The Gebharts' Sales of MHP Notes

Without providing to, or receiving from, MSC any additional communications about the program, the Gebharts began selling MHP notes in early 1997. Alvin and Donna Gebhart jointly served their clients, including determining whether the MHP notes were suitable for them. In general, both Gebharts were present for client meetings, but Alvin Gebhart did most of the talking.

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[5] The Hearing Panel did not find credible Poston's testimony that he received from Alvin Gebhart only a few newspaper clippings and a few abstracts of examples of trailer park conversions. We do not disturb the Hearing Panel's credibility determination

Alvin Gebhart testified that, when meeting with clients, he presented "a variety of investment strategies" and discussed the MHP notes as one alternative that would "fit in [clients'] portfolio[s], based on their objectives." The Gebharts provided customers with CSG/MHP promotional materials, such as descriptions of projects, newspaper clippings, testimonials, and descriptions of CSG's resident acquisitions program. Alvin Gebhart informed potential investors that the MHP notes were "secured by [a] recorded deed of trust" and that "if the worst case scenario came down they would be part owners of that [trailer] park." Likewise, Donna Gebhart sometimes explained to potential investors that the investments were secured by a trust, that noteholders would be owning a piece of a trailer park, and that HUD was involved. The Gebharts also informed their customers that MSC "had reviewed the information on this investment." Alvin Gebhart testified that he told customers that an MHP note "had risks to it," and he denied ever characterizing the MHP notes as safe. Alvin Gebhart did not, however, inform his clients about the financial condition of CSG or MHP, nor did he inform them that he would receive a commission on any transactions in MHP notes.

From January 1997 to February 2000, the Gebharts sold more than $2.36 million of MHP notes to 45 clients, including more than $62,000 in notes sold to themselves. Donna Gebhart testified that Archer "always assured" them that the parks "were in good shape" and "had a lot of equity in them." Until April

2000, MHP made monthly interest payments due under the existing notes. The Gebharts delivered "Gebharts & Associates" account statements and financial analyses to customers that listed their MHP investments under various categories, such as "fixed annuities," "mutual funds," and "unit investment trusts." CSG provided deeds of trust to clients who specifically requested them and to entities that administered clients' retirement accounts, such as First Regional Bank, when funds in such accounts were used to invest in MHP notes. The trust deeds, however, never contained recording information.

For the Gebharts' sales, Archer received 10 percent commissions, out of which he paid the Gebharts commissions of six percent for new investments and three/four percent for reinvestments. From 1997 through 1999, the Gebharts received $104,634 in commissions.

F. The Gebharts' Relevant Communications with MSC

The Gebharts made numerous representations to MSC concerning the extent of their outside business activities. In August 1997, the Gebharts completed MSC's 1997 Compliance Survey, in which they acknowledged they: (1) had read, and understood their responsibility to follow, the MSC compliance procedures set forth in the policies and procedures manual; (2) had notified MSC, in writing, of all outside business relationships for which they received

compensation; and (3) had not engaged in private securities transactions as defined in MSC's manual without written approval. From January through August 1997, however, the Gebharts sold 11 MHP notes raising $135,495.19.

On November 17, 1997, Joshua Helmle ("Helmle"), a compliance auditor, conducted MSC's first audit of the Gebharts' branch office. Among the materials that respondents provided to Helmle for his review were computer-generated business logs that included entries for the MHP transactions, described as "Fixed 1 Yr (Trailer Park)" and "trailer park investment."[6] Helmle's review of the Gebharts' office was favorable. As part of the audit, the Gebharts completed MSC's Representative Questionnaire, which asked, among other things, whether the representative: (1) had "received compensation from a source other than MSC for initiating or processing a transaction in *any type* of investment"; and (2) participated in any offering of general partnership interests, commercial paper, promissory notes, or joint venture participations other than through MSC. Respondents answered "no" to both questions, despite the fact that, in 1997, they earned $7,401 in commissions by selling MHP notes. Respondents generally testified that they answered "no" because they believed they had already disclosed all of their outside business activities and did not

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[6] The Hearing Panel did not credit Helmle's testimony that the logs he reviewed did not include the MHP transactions. We do not disturb this determination.

need to disclose them again. Alvin Gebhart further testified that he believed the questions related to securities transactions and did not concern the MHP notes.

In July and August 1998, the respondents again represented on MSC's 1998 Compliance Survey that they had not engaged in any unapproved private securities transactions and that they had provided MSC with written notice of all outside business relationships for which they received compensation. However, from September 1, 1997 through July 1998, the Gebharts sold $414,428.88 in MHP notes. In 1998, the Gebharts earned $21,510 in commissions from their sales of MHP notes.

On September 14, 1998, Alvin Gebhart and Linda Prijic ("Prijic"), office manager for Gebhart & Associates, inquired with MSC's operations department about how a client could purchase for a 403(b) account a "note on the 2nd deed of trust on the trailer park investment" and attached a copy of an MHP note. After receiving additional information, on September 24, 1998, MSC's operations department forwarded to respondents a wire from MSC's clearing firm approving the MHP notes for the 403(b) account. Poston testified that MSC's operations department has no responsibilities for reviewing or approving outside business activities.

In February 1999, Helmle conducted a second audit of the Gebharts' office for MSC. Helmle's audit report reflects that the Gebharts' main sources of

revenue were securities sales, insurance sales, and investment advisory services, but did not identify any other sources. The audit report also inaccurately indicated that the Gebharts' office did not prepare its own monthly statements. In connection with the audit, the Gebharts represented on a questionnaire that they understood Rule 3040's prohibition on selling away and had not engaged in any private securities transactions. The questionnaire also asked whether the Gebharts had issued or participated in any offering of promissory notes other than through MSC. To this question, Alvin Gebhart answered "yes" and wrote "2nd Deeds of Trusts." Donna Gebhart provided a similar response but also added, "Investment by Rep & Clients." Alvin Gebhart testified that he answered "yes" because he had a better understanding of the form than he did in 1997.[7]

On October 6, 1999, the Gebharts, for the third year in a row, acknowledged on MSC's annual compliance survey that they had provided MSC with written

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[7] The extent to which Helmle discussed these "yes" responses with the Gebharts is unclear. Alvin Gebhart did not remember any discussions with Helmle about the MHP notes. While Donna Gebhart remembered that she and Alvin Gebhart discussed their responses with Helmle, she did not remember the whole conversation, adding that "we would have answered [Helmle] truthfully." Helmle testified that the Gebharts told him that they and a few of their clients had invested in this particular investment "via a mutual friend." The Hearing Panel, however, found that Helmle's testimony concerning his audit and his conversations with the Gebharts was not reliable. We find no reason to disturb the Hearing Panel's credibility determination.

notification of all outside business relationships for which they received compensation and had not engaged in private securities transactions without prior written approval. In 1999, however, the Gebharts earned $75,723 in commissions from sales of the MHP notes.

G. The Collapse of CSG and MHP

In a letter dated April 4, 2000, Scovie, president of CSG, informed MHP noteholders that he had been diagnosed with brain cancer in January 2000, had been unable to participate in the operations of CSG, and that interest payments then due under the notes would not be made. One month later, Scovie again wrote to noteholders, explained that it was not possible to make interest or principal payments, and described the steps he was taking to resume payments. Scovie also disclosed that CSG had not recorded all of the investors' deeds of trust and that, of the approximately $3,670,000 in existing notes, only $605,000 was secured by recorded deeds of trust. The Gebharts immediately began taking steps to try to protect their clients' interests, including informing MSC about the collapse and filing for an involuntary bankruptcy proceeding against MHP. On August 11, 2000, MSC terminated the Gebharts' registrations. The Gebharts' customers ultimately filed a class action lawsuit against the Gebharts and MSC. *Tickel et al. v. Alvin Gebhart Jr. and Mutual Service Corp.*, No. GIC 759642 (Cal. Super. Ct.) (action filed Dec. 18, 2000).

III. Procedural History

On December 13, 2002, Enforcement filed a four-cause complaint against Alvin Gebhart, Donna Gebhart, and Archer concerning their sales of the MHP notes from December 1994 to February 2000. The only pertinent allegations are those raised in the first three causes against the Gebharts.[8] Cause one of the complaint alleged that the Gebharts offered and sold promissory notes issued by MHP that were not registered as securities, in violation of Section 5 of the Securities Act of 1933 ("Securities Act") and NASD Conduct Rule 2110. Cause two alleged that the Gebharts made misrepresentations and omissions of material facts in the sale of MHP notes, in violation of Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), Rule 10b-5 thereunder, and NASD Conduct Rules 2110 and 2120. Cause three alleged that the Gebharts sold the MHP notes without providing prior written notification to, or receiving prior approval from, MSC, in violation of Conduct Rules 2110 and 3040. The Gebharts jointly filed an answer, in which they generally denied the allegations, raised several affirmative defenses, and asserted that mitigating circumstances existed. On February 9, 2004, the Hearing Panel issued its decision, finding that

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[8] On June 25, 2004, a default decision found that Archer acted as an unregistered broker, fraudulently offered and sold unregistered securities, and engaged in private securities transactions without approval of his firm. Archer was barred from associating with any member firm.

Alvin Gebhart, assisted by Donna Gebhart, offered and sold unregistered securities through negligent material omissions without providing prior written notice to, or obtaining prior approval from, MSC and imposing sanctions. The Hearing Panel declined, however, to find that the Gebharts fraudulently sold the MHP notes.

On March 8, 2004, the Review Subcommittee called this matter for review. During the appellate proceedings, respondents filed a Motion for Leave to Introduce Additional Evidence to Supplement the Record, whereby they sought to introduce 16 additional exhibits. A subcommittee of the NAC ("Subcommittee") granted respondents' motion in part, admitting into evidence six paragraphs of a declaration of Alvin Gebhart, in which he declared he may have an inability to pay the sanctions.[9] Respondents were informed

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[9] In their motion, respondents sought to introduce four categories of documents: (1) NASD BrokerCheck records showing certain disciplinary information for other persons allegedly involved in the relevant events (including MONY, MSC, and some of their associated persons); (2) unsworn declarations of 10 customers, generally recounting their favorable impressions of the Gebharts; (3) a declaration of an attorney who represented the plaintiff classes in *Tickel* and in a separate class action against Archer and MONY, comparing the settlements obtained by the classes; and (4) a declaration of Alvin Gebhart, in which he sought to authenticate the proposed exhibits and asserted his inability to pay. Except as explained in the text, the Subcommittee denied respondents' motion because respondents failed to demonstrate, as to some proposed evidence, good cause for failing to introduce the evidence below or, as to other proposed evidence,

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that, should they wish to introduce evidence of Alvin Gebhart's inability to pay, they were required to document his financial status. On September 25, 2004, respondents submitted a Statement of Financial Condition of Alvin and Donna Gebhart.

IV. Discussion

As explained below, we affirm the Hearing Panel's findings that the Gebharts sold unregistered securities that were not exempt from registration and that they engaged in private securities transactions for compensation without providing written notice to, or receiving written approval from, their firm. We disagree, however, with the Hearing Panel's findings that the Gebharts' sales of the MHP notes involved only negligent omissions of material information. We find that the Gebharts' conduct was much more serious than that and hold that their omissions of material fact were reckless.[10]

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why the evidence was material. See Procedural Rule 9346(b). We adopt the Subcommittee's rulings.

[10] The complaint alleged that Donna Gebhart was liable as a primary violator. It is unclear whether the Hearing Panel evaluated Donna Gebhart's liability as a primary violator or, instead, as an aider and abettor. To the extent that the Hearing Panel found Donna Gebhart liable as an aider and abettor, we dismiss those findings.

A. Sales of Unregistered Securities

Section 5 of the Securities Act makes it unlawful for any person to make a sale, or any offer for sale, of a security for which no registration statement is in effect, unless there is an exemption from registration. *Michael A. Niebuhr*, 52 S.E.C. 546, 549 (1995). Scienter is not an element of a Section 5 violation. *Butcher & Singer, Inc.*, 48 S.E.C. 640, 643 (1987). The Gebharts sold the MHP notes, stipulated that no securities registration statement was in effect for the MHP notes, and have made no claim that the MHP notes were exempt from registration. Whether the Gebharts are liable for violating Section 5, therefore, turns on whether the MHP notes were securities.

We agree with the Hearing Panel that the MHP notes were securities. Section 3(a)(10) of the Exchange Act defines security to include any "note . . . but shall not include any note . . . which has a maturity at the time of issuance not exceeding nine months." As the Supreme Court held in *Reves v. Ernst & Young*, 494 U.S. 56, 62-63 (1990), however, the definition of "security" should not be interpreted to encompass literally all notes. "Congress' purpose in enacting the securities laws was to regulate *investments*," and notes are used "in a variety of settings, not all of which involve investments." *Id.* at 61-63. To distinguish notes that are securities, the Court adopted the so-called family resemblance test. Under that test, a note is presumed to be a security, and that presumption may be rebutted only by a showing that the note bears a strong resemblance to one of several

enumerated categories of non-securities notes, based on four factors (the "*Reves* factors").[11] If a note is not sufficiently similar to one of the enumerated categories, the family resemblance test requires an examination, using the same four factors, to determine whether another category should be added. *Id.* at 67. We conclude, after applying the family resemblance test, that the MHP notes neither bear a strong resemblance to any of the enumerated categories of non-securities notes nor belong to a category that should be added.

The first *Reves* factor is the motivation that would prompt a reasonable seller and buyer to enter into the transaction. "If the seller's purpose is to raise money for the general use of a business enterprise or to finance substantial investments and the buyer is interested primarily in the profit the note is expected to generate, the instrument is likely to be a 'security."D' *Id.* at 66. This factor strongly suggests that the MHP notes were securities. MHP's motivation in selling the promissory notes was to raise money to

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[11] The enumerated non-securities notes are "the note delivered in consumer financing, the note secured by a mortgage on a home, the short-term note secured by a lien on a small business or some of its assets, the note evidencing a 'character' loan to a bank customer, short-term notes secured by an assignment of accounts receivable, or a note which simply formalizes an open-account debt incurred in the ordinary course of business (particularly if, as in the case of the customer of a broker, it is collateralized)." *Reves*, 494 U.S. at 65 (citing *Exchange Nat'l Bank of Chicago v. Touche Ross & Co.*, 544 F.2d 1126, 1138 (2d Cir. 1976)).

purchase numerous parks for its resident acquisitions program. As such, we find that MHP's motivation was to "raise money for the general use of a business enterprise." *Id.* at 66.[12] Furthermore, the record demonstrates that the buyers' interest in the MHP notes was primarily – if not exclusively – to receive a very generous interest rate of 14 to 19 percent. *Id.* at 67-68 & n.4; *Stoiber v. SEC*, 161 F.3d 745, 750 (D.C. Cir. 1998).

The second *Reves* factor is the plan of distribution of the instrument to determine whether there is common trading for speculation or investment. *Reves*, 494 U.S. at 66. To establish "common trading," all that is required is a showing that the instruments are "offered and sold to a broad segment of the public." *Id. at 68.* CSG's method of distribution of its notes was limited, in that it apparently relied only on Archer and the Gebharts. There is no evidence that the notes were advertised, that any member firm put the notes on its approved product list, or that there were any secondary market sales. However, the Gebharts sold the MHP notes to approximately 45 individuals, and Archer sold MHP notes to a similar number of customers. While there is no apparent bright line test for how many investors satisfy the second *Reves* factor, we find that the number of customers who invested in MHP notes is high enough to

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[12] That the MHP notes raised money for the general use of a business strongly indicates that the MHP notes were unlike any of the enumerated non-securities notes.

demonstrate common trading. *SEC v. Current Fin. Servs.*, 100 F. Supp. 2d 1, 5 (D.D.C. 2000) (holding that sales to 570 investors, with the use of newspaper advertisements, demonstrated sales to the public), *aff'd sub nom. SEC v. Rayburn*, 22 Fed. Appx. 1 (D.C. Cir. 2001) (unpublished); *Dist. Bus. Conduct Comm. v. Kunz*, Complaint No. C3A960029, 1999 NASD Discip. LEXIS 20, at *18 (NAC July 7, 1999) (holding that the solicitation of more than 100 unrelated persons indicates that the products were securities), *aff'd, Kevin D. Kunz, Exchange Act Rel. No. 45290, 2002 SEC LEXIS 104 (Jan. 16, 2002), aff'd, 64 Fed. Appx. 659 (10th Cir. 2003) (unpublished)*; *cf. SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953)* (holding that the Securities Act registration requirements apply to "a 'public offering' whether to few or to many").

The third *Reves* factor – the reasonable expectations of the investing public concerning whether the instrument is a security – strongly suggests that the MHP notes were securities. The Court explained that the "fundamental essence of a "security' [is] its character as an 'investment."D' *Reves*, 494 U.S. at 68-69. Alvin Gebhart discussed the MHP notes with clients as an "investment vehicle," and Donna Gebhart testified that she and Alvin Gebhart recommended the MHP notes because they had short-term maturities and paid a favorable, fixed rate of interest. Moreover, the Gebharts mailed account statements that listed customers' investments in the MHP notes under categories such as "mutual funds" and "annuities." Given

these circumstances, a reasonable person would perceive the MHP notes to be investments.

The fourth *Reves* factor is the existence of a factor that significantly reduces the risk of the instrument, such as another regulatory scheme, thereby rendering the application of the Securities Acts unnecessary. *Reves*, 494 U.S. at 67. Securing each MHP note with a deed of trust on a given property with sufficient equity certainly might have helped reduce the risk of the MHP notes. In this case, however, any collateralization was "fiction," because CSG failed to record deeds of trust on the properties purportedly securing each note. *SEC v. J.T. Wallenbrock & Assocs.*, 313 F.3d 532, 539-40 (9th Cir. 2002). Moreover, respondents have not demonstrated that any comprehensive, alternative scheme of regulation protected investors in the MHP notes, nor are we aware of any. *Cf. Pollack v. Laidlaw Holdings*, 27 F.3d 808, 815 (2d Cir. 1994) (holding that there was no alternative regulatory scheme governing uncollateralized, oversubscribed mortgage participations, defined as short-term loans for construction and cooperative conversions).

Viewed against the *Reves* factors, therefore, we affirm the Hearing Panel's findings that the MHP notes were "notes" within the meaning of the Exchange Act and, therefore, securities. Accordingly, the Gebharts violated Conduct Rule 2110 by offering and

selling unregistered securities that were not exempt from registration.[13]

B. Private Securities Transactions

We also affirm the Hearing Panel's finding that the Gebharts, by selling MHP notes, engaged in private securities transactions without providing prior written notice to, or receiving prior written approval from, MSC. Conduct Rule 3040(b) provides that "[p]rior to participating in any private securities transaction, an associated person shall provide written notice to the member with which he is associated describing in detail the proposed transaction and the person's proposed role therein and stating whether he has received or may receive selling compensation in connection with the transaction." In cases where an associated person may receive selling compensation, a member firm must inform the associated person in writing whether it approves or disapproves of the private securities transaction. Conduct Rule 3040(c). Scienter is not required for a Rule 3040 violation. *Dep't of Enforcement v. Fergus*, Complaint No. C8A990025, 2001 NASD Discip. LEXIS 3, at *44 n.30 (NAC May 17, 2001), *aff'd sub nom. Frank Thomas Devine*, Exchange Act Rel. No. 46746, 2002 SEC LEXIS 2780 (Oct. 30, 2002). A violation of Rule 3040

[13] Rules that apply to an NASD "member", like Conduct Rules 2110 and 2120, apply to all members and to persons associated with a member. NASD Rule 115(a).

is also a violation of Rule 2110. *Chris Dinh Hartley*, Exchange Act Rel. No. 50031, 2004 SEC LEXIS 1507, at *9-10 (July 16, 2004).

The Gebharts' sales of MHP notes constituted "private" securities transactions. A private securities transaction is defined as "any securities transaction outside the regular course or scope of an associated person's employment with a member." Conduct Rule 3040(e)(1). From January 1997 to February 2000, the Gebharts sold approximately $2.4 million in MHP notes to about 45 different customers in 117 transactions and earned more than $104,634 in commissions. The MHP notes, however, were not on an MSC approved product list, and the Gebharts' sales were not recorded on MSC's books and records. *See Dep't of Enforcement v. Vastano*, Complaint No. C3A020013, 2003 NASD Discip. LEXIS 41, at *14-15 (NAC Dec. 5, 2003) (holding that sales of investments, which were not on an approved product list or recorded on member firm's books, were private securities transactions), *aff'd*, *Joseph Vastano, Jr.*, Exchange Act Rel. No. 50219, 2004 SEC LEXIS 1806 (Aug. 19, 2004).

In addition, the Gebharts failed to provide MSC with advance written notice of, or receive prior written approval for, their sales of the MHP notes. Alvin Gebhart supplied Poston with written materials concerning the CSG program and, in a letter, asked Poston to review that information. This letter, however, fell far short of the detailed written notice required by Rule 3040. The materials included an "investment summary" – evidently for notes sold in

connection with one particular mobile home park – that summarized the total amount CSG sought to raise, the interest rate paid to investors, the length of the notes, the purported collateral, and the expected use for the proceeds. The written materials did not, however, include a sample promissory note, explain Archer's role, or explain the breadth of the CSG/MHP program. Most significantly, the letter did not explain the Gebharts' proposed role or that they would receive selling compensation or indicate that the Gebharts planned to sell the MHP notes. *Cf. Dep't of Enforcement v. Van Dyk*, 2004 NASD Discip. LEXIS 12, at *19 & n.19 (NAC Aug. 9, 2004) (finding that written notice was not detailed enough to comply with Rule 3040); *see also Dep't of Enforcement v. Hartley*, Complaint No. C01010009, 2003 NASD Discip. LEXIS 49, at *24 (NAC Dec. 3, 2003) (holding that detailed written notice is required to satisfy Rule 3040), *aff'd*, *Chris Dinh Hartley*, 2004 SEC LEXIS 1507. Accordingly, the Gebharts engaged in private securities transactions without proving written notice to, or receiving written approval from, their employer, in violation of Conduct Rules 3040 and 2110.

C. Fraudulent Sales of MHP Notes

Enforcement also alleged that the Gebharts fraudulently sold the MHP notes by: (1) imparting positive information concerning the risk and quality of the MHP investments while failing to disclose material negative information about MHP's business and financial condition and the risks associated with the

investment; (2) failing to disclose the substantial commissions received by Archer and the Gebharts for selling the MHP notes; and (3) not having an adequate basis for recommending the MHP notes. The Hearing Panel, which appears to have made findings only with respect to the last of these three allegations, found that the Gebharts negligently omitted their failure to conduct an adequate investigation. As explained below, we modify this finding and hold that the Gebharts' conduct was not merely negligent, but reckless.

A violation of Section 10(b) of the Exchange Act, Rule 10b-5 thereunder, and Conduct Rule 2120 "requires a showing that: (1) the misrepresentations or omissions were made in connection with the purchase or sale of a security; (2) the misrepresentations or omissions were material; and (3) the misrepresentations or omissions were made with scienter." *Dane S. Faber*, Exchange Act Rel. No. 49216, 2004 SEC LEXIS 277, at *13-14 & n.11 (Feb. 10, 2004) (citing *SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1467 (2d Cir. 1996)). Misrepresentations and material omissions are inconsistent with just and equitable principles of trade. *Id.* A fact is material if there is "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the total mix of information available." *Id.*; *Dep't of Enforcement v. Reynolds*, Complaint No. CAF990018, 2001 NASD Discip. LEXIS 17, at *28 (NAC June 25,

2001). We turn first to whether the Gebharts made material omissions.

1. Material Omissions

We affirm the finding that the Gebharts recommended MHP notes without an adequate basis. A broker has the obligation to investigate whether an investment is suitable prior to recommending such an investment to prospective investors. Recklessly recommending securities without an adequate basis falls within the scope of Section 10(b). "A securities dealer occupies a special relationship to a buyer of securities in that by his position he implicitly represents he has an adequate basis for the opinions he renders." *Hanly v. SEC*, 415 F.2d 589, 596 (2d Cir. 1969); *see also Willard G. Berge*, 46 S.E.C. 690, 693 (1976) ("A professional who recommends the unknown securities of obscure issuers is under a duty to investigate and to see to it that his recommendations have a reasonable basis."). In particular, the Commission has explained that a salesman cannot recommend the securities of obscure issuers – particularly debt securities – without reliable financial data. *Willard G. Berge*, 46 S.E.C. at 693. Nor can a salesman simply rely on an issuer's "self-serving statements." *Dan King Brainard*, 47 S.E.C. 991, 996 (1983); *see also Hanly*, 415 F.2d at 597 ("Where the salesman lacks essential information about a security, he should disclose this as well as the risks which arise from his lack of information.").

Respondents argue that Alvin Gebhart "did everything he could to make sure the trailer park deal was legitimate." We could not disagree more. For the most part, the Gebharts recommended MHP notes to customers simply on the basis of information that Archer provided to them and the fact that the first three of their customers who invested had not complained. The Gebharts testified that they did not see, nor ask to see, any financial statements for CSG/MHP. Alvin Gebhart also admitted that he: (1) did not know into which bank accounts customers' investments would be deposited; (2) did not know or ask about the identities of CSG's shareholders, MHP's officers, or their compensation; (3) did not know the amount of Archer's compensation; (4) did not know the total amount of money that MHP was raising for each trailer park; (5) did not see evidence that nonprofit organizations were being formed; and (6) did not know the net worths of CSG or MHP. As for the purported collateral, Donna Gebhart testified that she never saw a recorded trust deed and Alvin Gebhart could not recall whether he had ever seen a recorded trust deed. The Gebharts' only independent research was to visit two mobile home parks, and it is not clear what insight the Gebharts gained other than the fact that the parks existed. In short, the Gebharts wholly failed to ensure that they had an adequate basis to recommend the MHP notes.[14]

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[14] Respondents blame "the realtor in the transaction" for not making full disclosure to the lenders about the notes and the

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As a result of their failure to investigate diligently the MHP notes, the Gebharts failed to learn or disclose to customers material negative information about MHP's financial condition and the risks associated with the MHP notes. The Gebharts represented to their clients – through in-person solicitations, promotional materials, and the text of the promissory notes themselves – that the MHP notes would be secured by deeds of trust on mobile home parks. The Gebharts failed to learn or disclose, however, that the owners of CSG and MHP failed to record the deeds of trust, leaving the Gebharts' customers with unsecured investments. In addition, the Gebharts failed to learn or disclose that each park was substantially overencumbered, subjecting the investors to the risks that MHP's assets and income would be insufficient to continue paying investors interest and principal. Misrepresentations and omissions concerning the financial condition of the issuer and the risks associated with an investment, such as these, are material.[15] *See Dep't of Enforcement v. Reynolds*, 2001

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collateral and assert that they encouraged their customers to visit the mobile home parks. Registered representatives, however, cannot shift to others their independent duty to ensure that they have an adequate basis to recommend a security. *Dane S. Faber*, 2004 SEC LEXIS 277, at *21.

[15] Enforcement further alleged that respondents did not disclose that MHP's ability to pay investors was, in turn, "dependent upon one man's ability to run the trailer park business," noting that MHP failed in June 2000 after Scovie became critically ill. The preponderance of the evidence, however, does not support Enforcement's allegation. When the Gebharts were

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NASD Discip. LEXIS 17, at *29 (holding that a reasonable investor would consider significant information pertaining to an issuer's financial condition and profitability); *SEC v. Hasho*, 784 F. Supp. 1059, 1109 (S.D.N.Y. 1992) (failure to disclose risk factors is a material omission).[16]

The Gebharts also failed to disclose the commissions that they and Archer earned, which totaled 10 percent. A broker's failure to disclose the commissions he makes is a material omission. *Hasho*, 784 F. Supp. at 1110 ("Misrepresenting or omitting to disclose a broker's financial or economic incentive in connection with a stock recommendation constitutes a violation of the anti-fraud provisions."); *see also Michael Niebuhr*, 52 S.E.C. 546, 552 (1995) (salesperson must disclose all material facts, including self-interest that could influence a recommendation). In this case, the amount of the commissions was important to

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selling the MHP notes, both Scovie and Mounier were involved in the operations of CSG and MHP. Mounier left CSG/MHP on February 18, 2000, one week after the Gebharts sold their last MHP note. There is nothing that indicates whether, while Mounier was working for CSG/MHP, operations could have continued without Scovie.

[16] Our findings with respect to the Gebharts' misrepresentations and material omissions do not rely on the testimony provided by the Gebharts' customers at the hearing. The Hearing Panel did not make determinations as to the customers' credibility, and we decline to make such determinations. For similar reasons, we do not rely on the testimony provided by the Gebharts' customers in depositions taken in the class actions against Archer and Alvin Gebhart.

reasonable investors because of what it meant concerning the Gebharts' incentives as well as the risks of investing in the promissory notes. Given that the notes carried interest rates between 14 and 19 percent, the healthy commissions paid meant that MHP had to earn a significant rate of return to pay the commissions and meet the interest payments.

Accordingly, we find that respondents made material omissions and recommended securities without an adequate basis. We now turn to whether respondents possessed the requisite scienter.

2. Scienter

Scienter requires proof that a respondent intended to deceive, manipulate, or defraud, or that he acted recklessly. *Dep't of Enforcement v. Apgar*, Complaint No. C9B020046, 2004 NASD Discip. LEXIS 9, at *16 (NAC May 18, 2004) (citing, *inter alia*, *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976), and *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1569 (9th Cir. 1990)); *see also Hanly*, 415 F.2d at 596 ("[A] salesman cannot deliberately ignore that which he has a duty to know and recklessly state facts about matters of which he is ignorant."); *Dane S. Faber*, 2004 SEC LEXIS 277, at *19 n.18 (holding that Rule 2120 requires showing of intentional or reckless conduct). The courts have defined recklessness as not merely simple, or even inexcusable negligence, but as "an extreme departure from the standards of ordinary care, and which presents a danger of misleading

buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." *Dane S. Faber*, 2004 SEC LEXIS 277, at *19 n.18 (quoting cases; internal quotation marks omitted); *Reynolds*, 2001 NASD Discip. LEXIS 17, at *44.

In finding that the Gebharts' failure to investigate was merely negligent – and therefore a violation only of NASD Rule 2110 – the Hearing Panel found that the Gebharts "truly believed that they had fulfilled their responsibilities to assure that MHP and CSG were appropriate investments." Enforcement argues that the Hearing Panel incorrectly considered the Gebharts' personal beliefs when deciding whether their conduct was reckless. The question of recklessness is primarily, but not exclusively, an objective test. In an excellent explanation of where the line is drawn in the context of material omissions, the Seventh Circuit has explained that recklessness is shown where "the danger of misleading buyers must be actually known or so obvious that any reasonable man would be legally bound as knowing and the omission must derive from something more egregious than even 'white heart/empty head' good faith." *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977) (footnotes omitted). The *Sundstrand* court pointedly explained that its recklessness test contains a subjective component and that recklessness would not be shown if, for example, ""a trial judge found . . . that a defendant genuinely forgot to disclose information or that it never came to his

mind." *Id.* at 1045 n.20; *cf. Kunz*, 1999 NASD Discip. LEXIS 20, at *45 n.21 (basing negligence finding on respondents' mistaken belief that they could rely on audited financial statements and an issuer's counsel to determine what information needed to be in a private placement memorandum); *Reynolds*, 2001 NASD Discip. LEXIS 17, at *46 (basing negligence finding on respondent's good faith, albeit unreasonable, beliefs about an issuer formed through a basic investigation). Nevertheless, ""good faith, without more, does not necessarily preclude a finding of recklessness." *SEC v. The Infinity Group Co.*, 212 F.3d 180, 192 (3d Cir. 2000). When evaluating a respondent's alleged good faith beliefs, we must "examine the foundation such a belief would have rested upon" because a good faith belief will not insulate respondents from liability "if it is the result of reckless conduct." *Id.* at 193.

With these principles in mind, we respectfully disagree with the Hearing Panel's finding that the Gebharts' failure to investigate resulted only from negligence. Instead, we find that their failure was reckless. The Hearing Panel based its finding about the Gebharts' true beliefs on four factors that, in our view, provided scant reasons for the Gebharts to believe they had fulfilled their duty to investigate. First, the Hearing Panel noted the Gebharts and three of their clients had a "one-year personal payment history" when they began directly selling MHP notes to customers. This payment history, however, was not substantial: only one of their customers had a year's

history with the MHP notes, and their own personal investment was only three months old. But more importantly, as Enforcement correctly argues, this payment history was not inconsistent with a Ponzi scheme.

Second, the Hearing Panel found that the "general information [the Gebharts] gathered about mobile home park conversions from HUD and other municipal and state agencies" supported their beliefs that they had investigated the notes. The record contains little evidence of what information the Gebharts actually gathered: Alvin Gebhart testified that he knew that HUD had processed "at least 1,100 loans" to assist persons "purchase their homes" and that a local municipality was "working on these mobile home park conversions." That possible sources of funding existed to finance the residents' acquisition of parks, however, offered the Gebharts no insight into the financial condition and business practices of CSG and MHP.

Third, the Hearing Panel noted MSC's "lack of response" to the information the Gebharts provided to it. This factor, however, is more relevant to whether the Gebharts thought they were authorized to sell the MHP notes than to whether they believed they had performed an adequate investigation. In any event, when faced with the uncertainty created by MSC's lack of response, the Gebharts did not press MSC to learn what its actual position was concerning the MHP notes. Moreover, a broker has a personal responsibility to conduct an investigation into securities he

recommends and cannot rely on either his employer or the issuer. *See Dep't of Enforcement v. Golub*, Complaint No. C10990024, 2000 NASD Discip. LEXIS 14, at *23 & n.17 (NAC Nov. 17, 2000).

Fourth, the Hearing Panel found that the Gebharts obtained information about the MHP notes from Archer, "whom they believed to be reliable." Even if we accept this finding, the Gebharts were confronted with numerous red flags that must have heightened their level of concern about the MHP notes. MHP and CSG were relatively unknown entities. The promissory notes usually described the purported collateral with little to no details, vaguely indicated that deeds of trust concerning that collateral would "ultimately" be recorded, and always indicated that, until then, the sole asset of MHP was a deed of trust worth only $100,000. *Cf. Dan King Brainard*, 47 S.E.C. at 998 (respondents ignored warning signals concerning the alleged collateral for securities). The Gebharts knew that their commissions were paid not from CSG or MHP corporate accounts, but from Archer's personal checking account. And the significant amounts of commissions and interest paid meant that MHP and CSG needed to earn impressive rates of return to meet those commitments. Despite these warning signs, the Gebharts proceeded to recommend and sell millions of dollars worth of notes issued by MHP, the financial condition of which the Gebharts knew nothing about. And although the Gebharts – who touted that the MHP notes were secured by deeds of trust on mobile home

parks – recognized the importance of the collateral, they took no steps to confirm that trust deeds were being recorded.[17]

In addition to the factors listed by the Hearing Panel, Alvin Gebhart testified that he believed the MHP program was acceptable because he thought that First Regional Bank was reviewing and analyzing the MHP notes before allowing them to be held in retirement accounts. Alvin Gebhart offers no reason, however, why his purported reliance on First Regional Bank was reasonable. There is no evidence that Alvin Gebhart attempted to verify that First Regional Bank was reviewing the MHP notes or obtaining recorded deeds of trust, or to inquire about what the bank's review entailed.

Alvin Gebhart's claim that he believed he fulfilled his duty to investigate is even more suspect in light of his experience in the industry. Contrary to the Gebharts' argument, Alvin Gebhart was not "relatively new to the securities industry when he joined MSC in 1996." As Alvin Gebhart explained to MSC, the year 2000 marked his "21st year in this field." In addition, the Gebharts sold the MHP notes for more

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[17] Respondents argue that Alvin Gebhart "had no access to information that would have contradicted any information Archer provided to them." Even if true, such lack of access itself would have been an additional red flag. *See Willard G. Berge*, 46 S.E.C. at 694 n.21 ("An unsuccessful effort to obtain financial data from an issuer that is selling massive quantities of securities is a red flag warning that something is probably awry.").

than three years; "[a]ny inexperience on respondents' part at the outset of that period should have disappeared long before its conclusion." *Dan King Brainard*, 47 S.E.C. at 1001. In fact, both Alvin and Donna Gebhart increased their knowledge of the industry during the relevant period, becoming registered general securities representatives within one and one-half years after commencing their direct sales of the MHP notes. *See Dane S. Faber*, 2004 S.E.C. LEXIS 277, at *20-21 (finding respondent acted recklessly in light of respondent's experience); *Michael J. Fee*, 50 S.E.C. 1124, 1126 (1992) (same).

Considering the totality of the evidence, we find that the Gebharts' omissions concerning the financial condition of MHP and the risks of the MHP notes, and their failure to investigate the MHP notes, derived from more than just empty-headedness. The Gebharts – who read MSC's procedures requiring private securities transactions to pass a due diligence investigation and who informed their customers that MSC had reviewed the notes – clearly recognized that customers would find it important that the MHP notes had been investigated. Their failure to investigate the MHP notes therefore represented an extreme departure from the standards of ordinary care and was reckless. *See Dan King Brainard*, 47 S.E.C. at 998-99 (finding that respondents who ignored obvious warning signals were at least "recklessly indifferent to the consequences of their actions"); *Willard G. Berge*, 46 S.E.C. at 694 (salesmen's failure to gather financial data about issuer was violation of antifraud

provision); *cf. Everest Sec., Inc.*, 52 S.E.C. 958, 963 (1996) (holding that respondents' claimed reliance on an investigator's due diligence investigation was reckless and a violation of NASD antifraud rule), *aff'd*, 116 F.3d 1235 (8th Cir. 1997).[18] We also find that the Gebharts' failure to disclose commissions was reckless. The danger of misleading customers was so obvious that the Gebharts must have been aware of it, and the Gebharts have not argued otherwise. Accordingly, we hold that respondents fraudulently omitted material facts and failed to have an adequate basis for recommending MHP notes, in violation of Section 10(b) of the Exchange Act, Rule 10b-5 thereunder, and NASD Conduct Rules 2120 and 2110.

V. Sanctions

The Hearing Panel fined Alvin Gebhart $100,000 and suspended him for 12 months in all capacities. The Hearing Panel fined Donna Gebhart $7,500 and

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[18] Respondents correctly argue that the Hearing Panel's negligence finding was grounded in a determination that the Gebharts credibly testified about their beliefs. Credibility determinations of the initial fact-finder, which are based on hearing the witnesses' testimony and observing their demeanor, are entitled to considerable weight and deference and can be overcome only where there is substantial evidence for doing so. *Dane S. Faber*, 2004 SEC LEXIS 277, at *17-18. As our discussion in the text demonstrates, however, this is the unusual case where there is substantial evidence for overcoming a credibility determination.

suspended her for seven months in her capacity as a general securities representative. As explained below, we think that the Gebharts' violations call for stronger sanctions.[19]

A. Private Securities Transactions and Sales of Unregistered Securities

For sales of unregistered securities in violation of Section 5 of the Securities Act and Rule 2110, the NASD Sanction Guidelines recommend imposing a fine between $2,500 and $50,000 and, in egregious cases, suspending a respondent for up to two years or imposing a bar. In assessing sanctions for this violation, we consider the principal considerations applicable to all guidelines and the considerations specific to selling unregistered securities. NASD Sanction Guidelines ("Guidelines") (2001 ed.) at 9-10 (principal considerations in determining sanctions), 30 (Unregistered Securities – Sales of).

For determining sanctions for private securities transaction violations, the Guidelines provide that the first step is to assess the extent of the transactions, including the dollar amount of sales, the number of customers, and the length of time over

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[19] We disagree with the Hearing Panel's aggregation of all violative conduct for sanctions purposes. Accordingly, we first assess sanctions for the Gebharts' private securities transactions and their sales of unregistered securities, and then turn to sanctions for their fraudulent conduct.

which the activity occurred. *NASD Special Notice to Members 03-65* (Oct. 2003), at 686. The Gebharts sold more than $2.36 million in MHP notes to 45 customers over a period that lasted more than three years. For private securities transactions like these exceeding $1 million, the Guidelines recommend, as a starting point, a fine between $5,000 and $50,000 and a 12-month suspension or a bar.

In addition to these primary considerations, the Guidelines direct that we consider 10 additional principal considerations and the general considerations applicable to all guidelines. *Id.* at 686-87; Guidelines at 9-10. Among these, there are numerous aggravating factors. The MHP notes were unregistered securities sold in violation of Section 5 of the Securities Act. Respondents attempted to create the impression that their firm sanctioned their sales of MHP notes, by corresponding with customers using letterhead that included the words "Securities offered by Mutual Service Corporation" and by informing customers that MSC had reviewed the MHP notes. The Gebharts' misconduct also clearly resulted in the potential for their monetary gain. Furthermore, the Gebharts sold MHP notes directly to customers of MSC, and the Gebharts' sales resulted in injury to the investing public.

Other considerations include whether respondents provided verbal notice of the details of the proposed transaction (and, if so, the Firm's verbal or written response) and the related consideration whether respondents intentionally misled their

employer or otherwise concealed their selling away. These considerations present close questions. Although the Hearing Panel found the Gebharts' verbal notice to be substantially mitigating, we do not. While Alvin Gebhart provided some degree of verbal notice to MSC about the CSG program, it is unclear how detailed that notice was, given that he failed to disclose he had already received finder's fees and his lack of detailed knowledge about the CSG program. Moreover, the Firm did not provide the Gebharts with verbal approval or a written response. As for whether respondents concealed their activities, they did not submit to MSC any investor-related documents or correspondence and repeatedly failed on questionnaires and surveys to disclose their private sales of MHP notes, despite questions that called for them to acknowledge such activities.[20] And in connection with the 1997 audit, the Gebharts evidently failed to disclose that they prepared their own monthly statements, which listed MHP transactions. Notwithstanding these troubling facts, the Gebharts did provide some degree of verbal notice, did not hide evidence of the MHP notes from Helmle, vaguely

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[20] The Hearing Panel credited the Gebharts' explanation that they believed they only had to disclose on representative questionnaires information about new programs with which they became involved. Nevertheless, none of the questions on the representative questionnaires limited responses to "new" programs. We also note that, in their 1997 representative questionnaire, respondents disclosed other "old" activities for which they had obtained approval, such as seminars they conducted.

disclosed their sales on a 1999 representative questionnaire as "2d deeds of trust," and sought approval from MSC to include the notes in a 403(b) account. Given these facts, the preponderance of the evidence does not demonstrate that respondents concealed their activities.

The Gebharts argue that they did not realize the MHP notes were securities because Archer told them that MHP notes were not securities. As a result, Alvin Gebhart allegedly thought that the MHP notes were "fixed income product[s], much like a fixed annuity," that MSC historically did not require be recorded on its books. The Gebharts' purported belief, however, lacked a reasonable basis. "A registered representative . . . may not rely on a colleague's interpretation of whether a particular transaction is covered by NASD Rule 3040." *Hartley*, 2003 NASD Discip. LEXIS 49, at *15 n.13. And other than reliance on Archer, respondents offer no explanation why they believed the MHP notes were akin to fixed annuities, an investment product that is offered by insurance companies. In addition, Donna Gebhart testified that they never approached any lawyers to determine whether the MHP notes were securities. In short, any belief that respondents had that the MHP notes were not securities was a "product of their own inattentiveness." *Kunz*, 1999 NASD Discip. LEXIS 20, at *70.

The Gebharts also argue that they were misled into believing they did not need written authorization to sell the notes because neither Poston nor the MSC auditor raised any questions about their activities.

Here too, respondents' purported beliefs were highly unreasonable. Registered representatives are responsible for knowing and abiding by NASD rule and regulations. *Hartley*, 2003 NASD Discip. LEXIS 49, at *31. In addition, the Gebharts annually acknowledged receiving and reading MSC's compliance manual, which explained that representatives were required to provide written notice of, and receive written approval for, private securities transactions. *Cf. Vastano*, 2003 NASD Discip. LEXIS 41, at *19 (noting that respondent ignored provision in compliance manual concerning private securities transactions); *Van Dyk*, 2004 NASD Discip. LEXIS 12, at *27-28 (holding that respondent's indifference toward NASD rules and firm procedures was reckless and an aggravating factor).[21]

The Hearing Panel stated that it was favorably impressed with respondents' remorse. While we have sometimes considered a respondent's contrition when assessing sanctions, *see Hanson*, 2001 NASD Discip.

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[21] Respondents contend that the MSC manual was deficient and unclear because it indicated that "real estate" activities did not require prior written approval and did not define "security." It is highly unreasonable, however, for an experienced securities professional to assume that a manual's use of the term "real estate" encompassed investments that had any ties to real property. And while the absence of a definition of "security" may sometimes mitigate selling away activities, here it does not, given respondents' registrations as general securities representatives, Alvin Gebhart's substantial experience, and language in the manual that, in essence, warned about the hazards of assuming a product is not a security without seeking advice from MSC.

LEXIS 41, at *19, an acceptance of responsibility is of most mitigative value when it is made *prior* to detection of the misconduct by a respondent's firm or a regulator. We also note that respondents dampen the effectiveness of their professed remorse by continuing to blame others – such as the MSC Compliance Department, realtors, and banks – for the fate that befell their customers. Accordingly, we have considered respondents' professed remorse but find that that it has little mitigative value. Likewise, while there is evidence that respondents cooperated with Enforcement's investigation, we find that such cooperation was not substantial enough to be mitigating.

We do find it slightly mitigating that respondents made efforts to assist customers in recovering their losses, including filing a bankruptcy action against MHP and suing their insurance provider to secure coverage for their personal liability. Through distributions from the bankruptcy estate and the settlement of the class action, it is expected that noteholders will receive 84 percent of their investments back. Nevertheless, remedial efforts are most mitigating when they occur prior to detection and intervention. In this case, the Gebharts' remedial efforts occurred only after MHP collapsed, which we view as the functional equivalent of detection, and therefore were not purely voluntary on their part. Moreover, requiring customers to pursue private litigation against their broker is not what we consider to be remedial conduct. And while the Gebharts assert they gave up any claim for their own losses, there is evidence that the Gebharts

did not personally contribute to cover the difference between the class action settlement amount and their insurance coverage.[22]

Disciplinary sanctions are remedial in nature and are designed to deter future misconduct and improve overall business standards in the securities industry. In light of the totality of the circumstances, the sanctions imposed by the Hearing Panel are not strong enough to serve these goals. Accordingly, we bar Alvin Gebhart for his violations of Rule 3040 and 2110. In light of the bar, we do not fine Alvin Gebhart, and his claim of inability to pay is, therefore, moot. As for Donna Gebhart, we agree with the Hearing Panel that she played a less substantial role. Nevertheless, Rule 3040 applies to representatives who participate "in any manner" in private securities transactions, language which the Commission interprets broadly. *Mark H. Love*, Exchange Act Rel. No. 49248, 2004 SEC LEXIS 318, at *7 (Feb. 13, 2004). Moreover, as a registered representative, Donna Gebhart bore the

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[22] Respondents assert that they incurred legal expenses in assisting customers and ask for credits of the amounts they helped their customers recover. No fine is imposed on Alvin Gebhart, so this request is moot as to him. While we do impose a fine on Donna Gebhart, respondents have provided no documentation of their legal expenses and, therefore, no evidentiary support for a credit. See Hanson, 2001 NASD Discip. LEXIS 41, at *24 n.22 (declining to offset against a fine undocumented legal expenses allegedly incurred to assist customers recover losses against bankrupt issuer). Because of this lack of documentation, we do not reach the question of what circumstances would warrant giving a credit.

same responsibilities as any registered representative. We therefore suspend Donna Gebhart for one year in all capacities, fine her $5,000, and order her to requalify before re-entering the industry.

B. Misrepresentations and Omissions of Material Fact

For reckless or intentional misrepresentations or omissions of material fact, the Guidelines recommend a fine between $10,000 and $100,000, and a suspension between 10 business days and two years or, in egregious cases, a bar. Guidelines at 96 (Misrepresentations or Material Omissions of Fact). In imposing sanctions for these violations, we consider the general principles applicable to all sanction determinations, which we discussed in the previous section. In light of these guidelines, we find that Alvin Gebhart's fraudulent solicitations were egregious, and we bar him for such conduct. As for Donna Gebhart, we impose a $10,000 fine, a one-year suspension in all capacities, and order her to requalify before re-entering the securities industry. Donna Gebhart has not demonstrated an inability to pay the fines imposed in this decision.

VI. Conclusion

Accordingly, we hold that Alvin and Donna Gebhart sold unregistered securities that were not exempt from registration; engaged in private securities transactions without providing written notice to, or receiving written approval from, their firm; and

recklessly omitted material facts in connection with the sales of securities, in violation of the Securities Act, the Exchange Act, and NASD Rules. For these violations, we bar Alvin Gebhart, which is effective upon service of this decision. For Donna Gebhart, we suspend her in all capacities for one year, impose a $15,000 fine, and order her to requalify before re-entering the securities industry.[23] The separate one-year suspensions imposed on Donna Gebhart shall be served concurrently. We also affirm the $5,141.21 in costs, joint and several, imposed by the Hearing Panel.

On Behalf of the National Adjudicatory Council,

Barbara Z. Sweeney,
Senior Vice President And Corporate Secretary

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[23] We also have considered and reject without discussion all other arguments advanced by respondents.

Pursuant to NASD Procedural Rule 8320, any member that fails to pay any fine, costs, or other monetary sanction imposed in this decision, after seven days' notice in writing, will summarily be suspended or expelled from membership for non-payment. Similarly, the registration of any person associated with a member who fails to pay any fine, costs, or other monetary sanction, after seven days' notice in writing, will summarily be revoked for non-payment.

NASD OFFICE OF HEARING OFFICERS

Department of Enforcement, Complainant, vs. Alvin W. Gebhart, Jr. (CRD NO. 1005905) Fallbrook, Ca, and Donna T. Gebhart, (CRD NO. 2708528) Fallbrook, Ca, Respondents.	Disciplinary Proceeding No. C02020057 HEARING PANEL DECISION Hearing Officer – SW Dated: May 24, 2005

For offering and selling unregistered securities, through negligent material omissions, without obtaining prior approval of his employer, in violation of NASD Conduct Rules 2110 and 3040, Respondent Alvin W. Gebhart, Jr. was suspended for 12 months in all capacities and fined $100,000.

For assisting Respondent Alvin W. Gebhart, Jr. to offer and sell unregistered securities, through negligent material omissions, without obtaining prior approval of her employer, in violation of NASD Conduct Rules 2110 and 3040, Respondent Donna T. Gebhart was suspended for 7 months in her capacity as

general securities representative and fined $7,500. The Hearing Panel also ordered the Respondents to pay jointly and severally the $5,141.21 costs of the Hearing.

Appearances

Sylvia M. Scott, Esq., Regional Attorney, and David A. Greene, Esq. Regional Counsel, Los Angeles, California, for the Department of Enforcement.

Charles F. Goria, Esq., and John H. L'Estrange, Jr., Esq., San Diego, California, for Respondents Alvin W. Gebhart, Jr. and Donna T. Gebhart.

DECISION

I. Procedural Background

On December 13, 2002, the Department of Enforcement ("Enforcement") filed a four-count Complaint against: (i) Alvin W. Gebhart, Jr. ("Respondent AG"), and his wife, Donna T. Gebhart ("Respondent DG"), (collectively, the "Gebharts" or the "Respondents"); and (ii) John T. Archer ("Mr. Archer"), concerning the sale of promissory notes issued by MHP Conversions, LLC, a California limited liability company ("MHP"). On March 11, 2003, the Hearing Officer held Mr. Archer in default for his failure to participate in a scheduled pre-hearing conference and for his failure to respond to an order to show cause.

Accordingly, the Hearing only addressed the allegations of counts one, two, and three of the Complaint against the Gebharts. Count one of the Complaint alleges that the Gebharts offered and sold unregistered securities, in the form of promissory notes issued by MHP, in violation of NASD Conduct Rule 2110. Count two of the Complaint alleges that the Gebharts sold the MHP promissory notes fraudulently, by failing to disclose material adverse information concerning MHP, in violation of Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), SEC Rule 10b-5, and NASD Conduct Rules 2110 and 2120. Count three of the Complaint alleges that the Gebharts failed to obtain prior written approval from their employer, Mutual Service Corporation ("Mutual Service"), before selling the MHP promissory notes, in violation of NASD Conduct Rules 3040 and 2110.

The Gebharts admitted participating in the sales of the MHP promissory notes, from 1997 to 2000, but they denied that the MHP promissory notes were securities. Accordingly, they denied that they sold unregistered securities, as alleged in count one of the Complaint. The Respondents also denied that they fraudulently failed to disclose material information about MHP, as alleged in count two of the Complaint. The Respondents denied that they failed to advise their employers of their activities, as alleged in count three of the Complaint.

On May 28-30, 2003, the Hearing Panel, composed of an NASD Hearing Officer and two current

members of the District 2 Committee, held a Hearing on this matter in Los Angeles, California.[1] At the request of the Hearing Panel, the Respondents filed a post-hearing submission on June 10, 2003, which was accepted by the Hearing Panel. Also at the request of the Hearing Panel, Enforcement and the Respondents filed post-hearing briefs on July 16, 2003. The Hearing Panel held deliberations on August 5, 2003 and December 15, 2003.

II. Findings of Fact and Conclusions of Law

A. Jurisdiction

1. Respondent AG

In May 1983, Respondent AG initially registered with NASD as an investment company and variable contracts products representative ("IC representative") with The Prudential Insurance Company of America ("Prudential"). (JX-1, p. 6; Stip. at T2). On January 30, 1996, Respondent AG became associated with Mutual Service as an IC representative. (JX-1, p. 4). On December 10, 1997, Respondent AG passed his Series 7 general securities representative qualifying examination and became associated with Mutual Service as a general securities representative. (Stip.

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[1] References to the testimony set forth in the transcripts of the Hearing will be designated as "Tr. p." with the appropriate page number. Enforcement exhibits will be designated as "CX-", and the Respondents' exhibits will be designated as "RX-GS-" with the appropriate page number or paragraph number.

at ¶ 2). On August 11, 2000, Mutual Service terminated the registrations of Respondent AG. (JX-1, p. 4).

2. Respondent DG

On February 13, 1996, Respondent DG initially became registered with NASD through Pacific Mutual as an IC representative. (Tr. p. 509). Subsequently, on February 14, 1996, Respondent DG became associated with Mutual Service as an IC representative. (Stip. at ¶ 3; JX-2, p. 4). On April 27, 1998, Respondent DG passed her Series 7 general securities representative qualifying examination and became associated with Mutual Service as a general securities representative. (Stip. at ¶ 3). On August 11, 2000, Mutual Service terminated the registrations of Respondent DG. (JX-2, p. 4).

3. The Respondents

The Respondents registered with Sentra Securities Corporation ("Sentra") as general securities representatives and IC representatives on August 7, 2000. (JX-1, p. 3; JX-2, p. 3). When the Complaint was filed against the Respondents on December 13, 2002, the Respondents were registered as general securities principals, general securities representatives,

and IC representatives with Sentra.[2] Accordingly, NASD has jurisdiction over the Respondents.

B. Background

1. Mobile home park conversion program

Community Service Group ("CSG") was formed in the early 1990s to manage mobile home parks and to facilitate conversion of the park from single ownership to multiple ownership by the park's residents.[3] (CX-50, p. 29). CSG initially established a separate entity owned by the principals of CSG, which took title and operated the park until the residents could purchase it. (Tr. pp. 478-479; RXGS-4). The separate entity obtained financing by selling notes secured by first and second trusts on the property.

MHP was created in 1997 to facilitate the financing of multiple conversions. (Tr. p. 678). MHP was to issue notes to obtain funds to acquire mobile home parks. (RX-90, p. 624). MHP would then subdivide the parks into individual lots corresponding to

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[2] On June 5, 2001, Respondent AG was registered with Sentra as general securities principal. (JX-1, p. 3). On July 3, 2001, Respondent DG was registered with Sentra as a general securities principal. (JX-2, p. 3).

[3] A mobile home park conversion was described as being very similar to the conversion of an apartment to a condominium through the formation of a homeowners' association. (Tr. pp. 469-470).

the number of spaces in the park, sell the individual lots to the mobile home park tenants and repay the notes when the lots were sold.[4] (Tr. pp. 836-837; RX-90, p. 624).

2. Chronology

a. The period prior to the Gebharts providing information to Mutual Service about the mobile home park conversion programs of CSG and MHP

Respondent AG began working for Prudential on June 1, 1980. (JX-1, p. 6). On May 16, 1983, Respondent AG became registered with Prudential as an IC representative, and his insurance product line expanded to include variable annuities and mutual funds. (JX-1, p. 6; Tr. pp. 373-375).

From March 1994 to January 1996, Respondent AG was registered as an IC representative with MONY Securities Corp. ("MONY"). (JX-1, p. 5). At MONY, Respondent AG's business also consisted primarily of insurance products and mutual funds. (Tr. p. 389).

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[4] The residents' purchase of the mobile home park was financed by a number of entities, including private financings, municipalities, the State of California, and the U.S. Department of Housing and Urban Development. (Tr. p. 660).

At MONY, Respondent AG met Mr. Archer, an IC representative. (Tr. pp. 417-418). Mr. Archer first became aware of the CSG mobile home park conversion program in 1993, through one of its employees, Mr. Mounier, whom Mr. Archer had known since the 1970s. (RX-GS-90, pp. 301-302). In June 1994, Mr. Archer began selling CSG promissory notes to certain of his clients. (RX-GS-90, p. 93).

In 1995, Mr. Archer discussed with Respondent AG the possibility of Respondent AG's clients investing in promissory notes issued by CSG to finance the purchase of mobile home parks. Mr. Archer explained that CSG would re-sell the land to the parks' residents, thereby converting the mobile home parks to residential ownership. (Tr. p. 420). Mr. Archer reported to Respondent AG that he had discussed the CSG mobile home park conversion program with a MONY compliance officer in 1994, and that the compliance officer had seen no problems with the program. (Tr. p. 827; RX-GS-90, pp. 98-102). Mr. Archer also told Respondent AG that he had several conversations with their MONY agency manager about the CSG program, and the agency manager did not see any problem with the program. (*Id.*).

Respondent AG had no reason to distrust Mr. Archer, he knew that his MONY agency manager recruited Mr. Archer to join MONY and spoke very highly of Mr. Archer. (Tr. p. 813). Subsequently, Respondent AG introduced three customers to Mr. Archer. (Tr. p. 419; Schedule B to Stip.). Based on Mr. Archer's presentation, the Respondents, as well as

three customers, purchased CSG promissory notes.[5] (Tr. pp. 419-420; Schedule B to Stip.).

On January 30, 1996, Respondent AG became associated with Mutual Service as an IC representative. (JX-1, p. 4). Respondent AG was located in his own office doing business as "Integrated Planning Service." (Tr. p. 562). Mutual Service provided Respondent AG with a number of written documents to assist him in setting up his office; but there was no on-site supervision. (Tr. pp. 279-280).

In June 1995, Respondent DG terminated her 25-year career as a court reporter because of injuries sustained in a 1994 car accident, and began assisting her husband in his business. (Tr. pp. 507-508). In February 1996, she became registered as an IC Representative with Mutual Service, sharing the office with Respondent AG. (Tr. p. 516). After the Gebharts' California office was set up, Mutual Service's home office principals in Florida served as the Respondents' supervising principals; there was no specific individual assigned the responsibility for supervising the Gebharts' office. (Tr. pp. 279-280).

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[5] On January 10, 1996, CSG executed a promissory note to Respondent AG's customer NM for $25,000. (CX-28, p. 3). On April 26, 1996, Respondent AG's customer RD invested $10,000 in the program; on May 10, 1996, Respondent AG's customer CW invested $10,000 in the program; on October 2, 1996, the Gebharts invested $7,000 in the program; and on October 3, 1996, a trust for CW and her husband invested an additional $20,000 in the program. (Schedule B to Stip.).

Mutual Service's Policies and Procedures Manual required representatives to disclose all relationships for which they would be remunerated prior to entering into such relationships, and provided that the Firm had the right to approve or disapprove any such activity. (CX-60, p. 2). The Firm's Policies and Procedures Manual discussed the requirement for approval of private securities transactions but did not provide a definition of a security. (CX-60, pp. 3-4).

In October 1996, Mr. Archer suggested that the Respondents present the CSG notes to their clients as possible investments. (Tr. p. 828). Mr. Archer described the program underlying the notes in greater detail, and again advised the Respondents that MONY had not objected to him selling the notes. (Tr. p. 827; RX-GS-90, pp. 223-224). Mr. Archer had advised the Respondents that the MHP promissory note was not a security. (Tr. p. 555). Mr. Archer, nonetheless, advised the Respondents to contact their employer to avoid selling away problems. (Tr. p. 826).

b. <u>Information concerning mobile home park conversion program provided to Mutual Service</u>

On October 23, 1996, Respondent AG called the Compliance Department of Mutual Service to discuss the CSG program and spoke with Michael Poston, Mutual Service's Compliance Director. (Tr. pp. 96-99, 828-829; CX-72). The Respondents testified that Respondent AG called the Compliance Department

specifically to confirm that there was no problem with their participation in the CSG program. (Tr. pp. 792, 828). Mr. Poston testified that he discussed the program with Respondent AG briefly, but it was his understanding that Respondent AG had not participated in, and was not interested in participating in, selling investments in mobile home park conversions.[6] (Tr. p. 361).

On the same day, Respondent AG sent Mr. Poston follow-up correspondence with information concerning the CSG mobile home park conversions that he had received from Mr. Archer. (Tr. p. 832; CX-72). There is no dispute that documents concerning CSG's mobile home program were sent to Mutual Service, but there is some disagreement about what was included.[7] (CX-72).

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[6] Mr. Poston testified "I asked him had he sold the products and he told me 'no,' so I took that as an indication that he again, had no interest in it." (Tr. p. 361).

[7] Both Mr. Poston and Respondent AG agreed that the materials included: (i) local newspaper articles concerning successful trailer park conversions; (ii) favorable "testimonials" representing what former mobile home park owners had allegedly said about CSG; and (iii) single page abstracts of various trailer park deals. (Tr. pp. 101-102, 107-108, 838). Respondent AG testified that the materials also included a description of the conversion process and pro forma financial information, but Mr. Poston denied that the material included those materials. (Tr. p. 837; RX-GS-24). Based on Respondent AG's demeanor, the Hearing Panel believed Respondent AG's testimony that the material he sent to Mr. Poston at Mutual Service included everything that he had received from Mr. Archer, including the

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Although Mr. Poston testified "I didn't know what to make of it," neither Mr. Poston, nor anyone from the Compliance Department, ever contacted the Respondents about the materials that had been sent.[8] (Tr. pp. 108, 290). On the other hand, the Respondents did not call Mutual Service's Compliance Department to follow-up on their correspondence. (Tr. pp. 837-838).

The Respondents erroneously assumed that the approval procedure for the CSG notes would be similar to the approval procedure for their other outside activities, such as insurance. (Tr. pp. 793, 838). In the past, after providing notice of an activity to Mutual Service, Mutual Service would contact the Respondents if there were issues with the activity, but Mutual Service would not contact them if there were no issues. (Tr. pp. 793, 838). Consequently, the Respondents sent in the notice, waited a period of time, and upon hearing nothing from the Firm, they began

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conversion process description. Mr. Poston's contrary testimony about the enclosures was based solely on his memory of looking at the material in 1996; Mr. Poston did not have the benefit of a copy of the enclosures in the Firm's files to confirm his memory. (Tr. pp. 292- 293).

[8] Mr. Poston testified that he assumed that Respondent AG had heard of mobile home park programs and was calling to find out if the Firm had a position on it. (Tr. p. 99). Mr. Poston testified that the telephone conversation was "just a general conversation." (Tr. p. 358). Mr. Poston had more than 800 representatives under his supervision at the time. (Tr. p. 278).

participating in the sale of the CSG notes.[9] (*Id.*). Respondent AG testified that, knowing that Respondent DG had spoken with Mr. Poston about the program, she "relied" on Mr. Poston to advise them if the CSG notes were securities. (Tr. pp. 557-558).

c. The period after documents sent to Mutual Service's compliance department but before the Respondents became general securities representatives

In February 1997, MHP was formed and began issuing all the promissory notes to finance CSG's mobile home park conversion program. (Tr. pp. 678-679). In 1997, the Respondents began to include the MHP notes as one of the investment options that they presented to their customers when proposing a financial plan. (Tr. p. 484).

In August 1997, the Respondents completed the Firm's July 30, 1997 Compliance Survey. (CX-65; CX-66). By executing the survey, among other things, the

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[9] Mutual Service's outside business activities section of its Manual stated, "These outside business activities must always be reported to the Compliance Department and, in some cases, must be approved by [Mutual Service] in writing before a Representative may proceed." (emphasis added). (CX-76, pp. 51, 124 and 198). There was no definition of the phrase "in some cases," and, therefore, no indication that, after reporting the CSG program as an outside business activity, the Respondents should wait for affirmative written approval from Mutual Service before participating in the sale of CSG notes.

Respondents represented that they: (i) had notified the Firm in writing of all outside business relationships for which they received compensation; and (ii) had not engaged in private securities transactions, as defined in the Firm's Policies and Procedures Manual, without written approval from the Firm's Compliance Department. (CX-65; CX-66). From January 1, 1997 to August 30, 1997, the Gebharts participated in 11 MHP promissory note transactions raising $378,195, including a $5,939.51 investment from the Respondents. (Schedule B to Stip.). Nevertheless, the Respondents believed their 1997 representations were true, because of their October 1996 communications to Mutual Service regarding the mobile home conversion program, and because they did not believe the MHP promissory notes were securities.

On November 17, 1997, Joshua Helmle, the Firm's compliance auditor, completed the first audit of the Gebharts' office. (RX-GS-25, pp. 1-5). The auditor reviewed the Respondents' business logs, which included the MHP transactions.[10] (RX-GS-26).

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[10] Mr. Helmle denied that the business logs included the MHP transactions and stated that the business logs were handwritten. (Tr. pp. 610, 612). The Respondents stated that the business logs were computer-generated. (Tr. pp. 568-569, 763). In her deposition testimony, Ms. LP, who was the Gebhart's office manager at the time, testified that the business logs were computed-generated. (RX-GS-72, pp. 26, 45). Ms. LP also confirmed that she input the MHP transactions into the Gebharts' business logs. (RX-GS-72, pp. 45, 64). The Hearing Panel found

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In connection with the audit, the Respondents each completed the Firm's Representative Questionnaire. (CX-63; CX-64). Among other things, the Questionnaire specifically asked (i) whether the representative had received compensation from sources other than the Firm for initiating or processing a transaction in any type of investment, and (ii) whether the representative had ever participated in any offering of general partnership interests, commercial paper, promissory notes, or joint venture participations other than through the Firm. (CX-63, p. 2; CX-64, p. 2). Respondent AG and Respondent DG each answered "no" to both questions.[11] (*Id.*). In 1997, the Respondents earned $7,401 in commissions on the MHP promissory notes program. (CX-77, p. 7).

d. <u>The period after the Respondents became general securities representatives</u>

On December 10, 1997, Respondent AG passed the Series 7 qualifying examination and became associated with Mutual Service as a general securities

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that Ms. LP had no reason to falsify her testimony in a manner favorable to the Respondents. Customer LT, the brother-in-law of Ms. LP, testified that Ms. LP terminated her relationship with the Gebharts on "less than friendly terms." (Tr. p. 66).

[11] At the time, Respondent DG believed that "no" was a correct answer because he was not receiving income from any entity that he had not already disclosed to Mutual Service. (Tr. pp. 532-533).

representative. (Stip. at ¶2). On April 1998, Respondent DG passed the Series 7 qualifying examination and became associated with Mutual Service as a general securities representative. (JX-2, p. 7).

In July 1998, the Respondents completed the Firm's 1998 Compliance Survey. (CX-68; CX-69). Among other things, the Respondents again represented that: (i) they had notified the Firm in writing of all outside business relationships for which they received compensation; and (ii) they had not engaged in private securities transactions as defined in the Firm's Policies and Procedures Manual, without written approval from the Firm's Compliance Department. (CX-68; CX-69). In making these representations, the Respondents again relied on their disclosure of information in October 1996 and their belief that the notes were not securities, even though from January 1998 to August 1998, the Gebharts had initiated 25 MHP promissory note transactions raising $369,429, including a $6,462.17 investment from the Respondents. (Schedule B to Stip.; CX-68; CX-69).

On September 14, 1998, the Respondents sent an inquiry to the operations department of Mutual Service regarding the appropriateness of MHP promissory notes for a 403(b) account of one their customers. (RX-GS-33). Mutual Service's operations department asked certain questions about the product on September 18, 1998, and ultimately approved the product for inclusion in the 403(b) account on September 24, 1998. (RX-GS-34; RX-GS-35).

On February 1, 1999, Respondent AG and Respondent DG each completed the Firm's 1999 Representative Questionnaires in connection with the 1999 audit of their office. (CX-70; CX-71). Among other things, the Representative Questionnaire specifically asked whether the representative had ever participated in any offering of general partnership interests, commercial paper, promissory notes, or joint venture participations other than through the Firm. (CX-70, p. 3; CX-71, p. 3). For fiscal year 1998, the Gebharts earned $21,510 from the MHP promissory note program. (CX-77, p. 7). Respondent AG answered "yes" and added the phrase "2nd deeds of trust." (CX-70, p. 2). Respondent DG answered "yes" and added the phrase "2nd deeds of trust/Investment by Rep & Clients."[12] (CX-71, p. 3).

Joshua Helmle, the Firm's compliance auditor, conducted the second audit of the Gebharts' office in February 1999, and reviewed the business logs and the Gebharts' 1999 Representative Questionnaires. (Tr. pp. 598-599). Mr. Helmle testified that, in reviewing the questionnaire, it was his understanding the Respondents had invested in the MHP promissory notes and that their clients had invested in the MHP promissory notes via a mutually known third party.[13]

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[12] As explained, the MHP promissory notes were purportedly secured by second deeds of trust on the mobile home parks.

[13] Mr. Helmle initially testified that he "absolutely" reviewed trade tickets during his audit of the Gebharts' office. (Tr.

(Continued on following page)

(Tr. pp. 598-599). Respondent DG does not remember what she specifically told Mr. Helmle regarding the second trust deeds during the audit. (Tr. pp. 574). Respondent AG does not remember any discussion about the mobile home park program in the 1999 audit. (Tr. p. 875).

On October 6, 1999, the Respondents completed a Compliance Survey for the Firm on behalf of Gebhart & Associates, the name under which their office did business. (CX-74). Once again, the Respondents represented that they: (i) had notified the Firm in writing of all outside business relationships for which they received compensation; and (ii) had not engaged in private securities transactions as defined in the Firm's Policies and Procedures Manual without the written approval of the Firm's Compliance Department. (*Id.*).

In November 1999, Mr. Archer received a letter, dated July 28, 1999, from MONY advising him that involvement in the sale of MHP promissory notes would be considered a private securities transaction

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pp. 646-647). Respondent AG testified that they had never worked with trade tickets, they executed transactions on Net Expo through Pershing. (Tr. p. 764). Mr. Helmle admitted that he had done "hundreds and hundreds of audits." (Tr. p. 612). Taking into consideration, the number of audits that Mr. Helmle had performed, the Hearing Panel found it unlikely that Mr. Helmle irrefutably remembered the audit and the conversations that he had with the Respondents. The narrative summaries created by Mr. Helmle for both the 1997 and 1999 audits could not be located. (Tr. p. 301).

under NASD Rule 3040. (RX-GS-90, p. 631). Mr. Archer did not advise the Gebharts that he had received the letter from MONY, or that their activities might be covered by Rule 3040. (RX-GS-90, p. 332). The Respondents earned $75,723.40 in commissions through the MHP program for fiscal year 1999. (RX-GS-79).

e. Problems with MHP program revealed

In January 2000, Mr. Scovie, the owner of CSG and indirect owner of MHP, was diagnosed with brain cancer, and in February 2000, Mr. Mounier, Mr. Archer's initial link to CSG, left MHP.[14] (CX-55, p. 75). In April 2000, Mr. Scovie wrote to the MHP note holders to advise them of his health condition, and to indicate that the March 2000 interest payments on the MHP promissory notes would not be paid. (CX-55, p. 79). The Respondents wrote Mr. Scovie to request more specific information concerning liquidation of the parks and payment of the notes. (RX-GS-81).

On May 3, 2000, Mr. Scovie wrote a second letter to the note holders in which he disclosed, among other things, the companies' failures to record the deeds of trust for the MHP promissory notes. (CX-55,

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[14] MHP was owned: (i) 50% by Evicos, Inc., a company owned by Mr. Scovie and his wife; and (ii) 50% by David W. Mounier, Inc., a company owned by Mr. Mounier and his wife. (Tr. pp. 678-679; RX-GS-11).

p. 75; CX-51, p. 38). The same day, the Gebharts wrote their customers and recommended that they execute and deliver notices of default to MHP. (CX-51, p. 35). The letters included a form for the notice of default.[15] (CX-51, p. 36).

In May 2000, the Gebharts advised their customers of their intention to pursue involuntary bankruptcy of CSG and its related entities. (CX-51, p. 41). In May 2000, the Gebharts wrote Mutual Service concerning the problems with the MHP promissory note program. (RX-GS-63). On June 22, 2000, the Federal Bankruptcy Court in San Diego, California approved the involuntary bankruptcy of CSG. (RX-GS-90, p. 136). On August 11, 2000, Mutual Service terminated the registrations of the Gebharts. (JX-1, p. 4; JX-2, p. 4).

Subsequently, the Respondents filed suit against their insurer and the insurer agreed to contribute $925,000 to the note holders. (Tr. p. 890). The Respondents anticipate that note holders will receive 84% of their principal. (*Id.*).

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[15] Customer LT confirmed that the Gebharts provided him with the notice default. (Tr. p. 70).

2. MHP promissory notes were securities

a. MHP

CSG was formed by Mr. Scovie to manage mobile home parks and facilitate their conversion to residential ownership. (CX-50, p. 29). MHP was created in 1997 to issue notes to obtain funds to acquire mobile home parks as the first step of the conversion process. (RX-90, pp. 624, 678). The typical MHP note was one year in duration and paid 11% interest on a monthly basis, with an additional 4-6% accrued on a monthly basis and paid on the maturity date. (Tr. pp. 499- 500).

b. Reves analysis

Section 3(a)(10) of the Securities Exchange Act of 1934 ("Exchange Act") includes in its definition of "security," "any note . . . but shall not include . . . any note . . . which has a maturity at the time of issuance of not exceeding nine months." Nevertheless, the courts have held that Congress did not intend that the definition encompass literally "all" notes. To distinguish notes that are securities from those that are not, the courts have developed a test to determine whether a particular note is of the type that Congress wished to encompass within the securities laws.

This "family resemblance" test was adopted by the Supreme Court in *Reves v. Ernst & Young,* 494 U.S. 56 (1990). It presumes that every note is a security unless, based on a four factor analysis, it

either: (1) bears a strong resemblance to certain types of notes recognized as being outside the securities laws; or (2) should be added to that list.

The four factors are:

(1) the motivations that would prompt a reasonable seller and buyer to enter into the transaction;[16]

(2) the plan of distribution of the notes;[17]

(3) the reasonable expectations of the investing public regarding whether the instruments were securities; and

(4) the presence of any alternative scheme of regulation or other factor that significantly reduces the risk of the instruments so as to make regulation under the securities laws unnecessary.

Considering these factors, the Hearing Panel finds that the MHP promissory notes are securities.

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[16] If the seller's purpose is to raise money for the general use of a business enterprise or to finance substantial investments and the buyer is interested primarily in the profit the note is expected to generate, the instrument is likely to be a "security." If the note is exchanged to facilitate the purchase and sale of a minor asset or consumer good, to correct for the seller's cash-flow difficulties, or to advance some other commercial or consumer purpose, on the other hand, the note is less sensibly described as a "security." *Reves* at 66-67.

[17] The *Reves* Court held that offer and sale to a "broad segment of the public" would establish the requisite common trading in an instrument. *Reves,* at 68.

First, MHP entered into the transaction to raise funds for its business of purchasing mobile parks, and the investors loaned the money to MHP with the expectation of earning profits in the form of interest. Thus, the motivations of a reasonable buyer and seller to enter the transaction weigh in favor of a finding that the MHP promissory notes are securities.

Second, it was estimated that millions of dollars worth of MHP promissory notes were sold to numerous customers. The Respondents alone sold over $2.4 million in MHP promissory notes in connection with 117 separate transactions. (Schedule B to Stip.). Accordingly, MHP's plan of distribution was to a "broad segment of the public," demonstrating that there was "common trading for speculation or investment."[18]

Third, the MHP investors reasonably understood that the notes were "investments," rather than consumer or commercial loans. Customer LT testified that he viewed the MHP promissory note as an investment, part of his "investment portfolio." (Tr. p. 58). Respondent DG admitted that she and Respondent AG offered the MHP promissory notes to their clients as an investment vehicle. (Tr. p. 485). Respondent AG also testified that their customers were attracted to the notes because of their short term of maturity and favorable rate-of-return. (Tr. p. 516).

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[18] *Id.* at 66-67.

And finally, there was a clear need for the protection afforded by the federal securities laws, as no other regulatory scheme was in place to reduce the risk of the MHP promissory notes.

Therefore, the Hearing Panel finds that, based on the Reves analysis, the MHP promissory notes do not resemble any one of the enumerated types of notes excluded from the definition of a security,[19] and finds, based on the same analysis, that they should not be added to the category of excluded notes. Accordingly, the MHP promissory notes were securities.

C. The Gebharts Offered and Sold Unregistered Securities in Violation of NASD Conduct Rule 2110

Section 5 of the Securities Act of 1933 prohibits the offer or sale of any security, unless there is a registration statement in effect as to that security, or there is an exemption available for that securities

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[19] The types of notes recognized as being excluded from the definition of a security are notes delivered in consumer financings, notes secured by mortgages on homes, short-term notes secured by liens on small businesses or some of the small businesses' assets, notes evidencing "character" loans from banks, short-term notes secured by an assignment of accounts receivable, notes which simply formalize an open-account debt incurred in the ordinary course of business, and notes evidencing loans by commercial banks for current operations. *Stoiber v. SEC*, 161 F.3d 745, 749 (D.C. Cir. 1998).

transaction.[20] And it is well settled that the burden of establishing an exemption from registration requirements rests upon those who claim it.[21] Section 5 of the Securities Act of 1933 imposes strict liability on offerors and sellers of unregistered securities; scienter is not a required element of a Section 5 violation.[22] Whether the offeror or seller knows that it is selling an unregistered security is irrelevant.[23] And "[t]here is no requirement that the actor also be aware that he is violating any Acts or Rules."[24]

It is undisputed that no registration statement under the Securities Act of 1933 had been filed or was in effect as to the MHP promissory notes. (Stip. at ¶ 7). There is no evidence that transactions were exempt.

Consequently, although the Respondents did not realize that the MHP promissory notes were securities, or that the MHP promissory notes should have been registered, their ignorance is not relevant to a

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[20] *SEC v. Softpoint, Inc.*, 958 F. Supp. 846, 859 (S.D.N.Y. 1997), affd, 159 F.3d 1348 (2d Cir. 1998).

[21] *See, e.g., In re First Pittsburgh Securities Corporation*, 47 S.E.C 299, 301 (1980). As one court has stated, "[t]he evidence [establishing the exemption] must be . . . explicit, exact, and not built on conclusionary statements of the [respondents]."

[22] *SEC v. Current Financial Services, Inc.*, 100 F. Supp. 2d 1, 5-6 (D.D.C. 2000), 2000 U.S. Dist. LEXIS 8475 (May 18, 2000).

[23] *Id.*

[24] *In re Kolar*, 1999 SEC LEXIS 2300, at *70 (Oct. 28, 1999).

finding of liability. Therefore, the Hearing Panel finds that the Gebharts violated NASD Conduct Rule 2110 by offering and selling securities that were not exempt from registration, and for which no registration statement had been filed, in violation of Section 5 of the Securities Act of 1933.

D. The Gebharts Omitted Material Information in Connection with the Offer and Sale of the MHP Promissory Notes, in Violation of NASD Conduct Rule 2110, but Fraud was not Proven

1. Fraud not proven

In order to establish a violation of the anti-fraud provisions of Section 10(b) of the Exchange Act, SEC Rule 10b-5, and NASD Conduct Rule 2120, Enforcement was required to prove, by a preponderance of the evidence, that:

(i) the Respondents made misrepresentations and/or omissions;

(ii) the misrepresentations and/or omissions were material;

(iii) the Respondents made the misrepresentations and/or omissions with scienter; and

(iv) the Respondents made the misrepresentations and/or omissions in connection with the purchase or sale of securities.[25]

In addition, the duty of fair dealing requires that stock brokers have an adequate basis for their recommendations, and those recommendations should be based on reasonable investigation.[26] As registered representatives, the Respondents, therefore, had an obligation to employ due diligence to discover material information about the investment they were selling.

The Gebharts failed to conduct a reasonable investigation of MHP or CSG. In fact, the Gebharts obtained all of the information they reported to their customers concerning the mobile home conversion program from Mr. Archer. The Gebharts had no substantial direct contact with the principals of MHP until after MHP had defaulted. The Gebharts knew nothing about the financial condition or the workforce of MHP or CSG.

The Gebharts disclosed that the MHP promissory notes were to be secured by second deeds of trusts, but they failed to disclose that they had done no due diligence to confirm independently that MHP was

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[25] *See DBCC v. Euripides*, No. C9B950014, 1997 NASD Discip. LEXIS 45, at *18 (NBCC July 28, 1997).

[26] *Hanly v. SEC*, 415 F.2d 589, 597 (2d Cir. 1969); Steven D. Goodman, Exch. Act. Rel. No. 43,889, 2001 SEC LEXIS 144, at *12 (Jan. 26, 2001).

actually completing and recording second deeds of trust, which, in fact, MHP was not doing.

The Hearing Panel finds, however, that the Gebharts did not act with scienter. They did not omit the information intentionally, nor were their omissions reckless. Recklessness is defined as an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious the actor must have been aware of it.[27]

The Respondents truly believed that they had fulfilled their responsibilities to assure that MHP and CSG were appropriate investments, based on: (i) the information they received from Mr. Archer, whom they believed to be reliable; (ii) the general information that they gathered about mobile home conversions from HUD and other municipal and state agencies; (iii) their one-year personal payment history with the MHP promissory note; and (iv) Mutual Service's lack of response to the information concerning the mobile home conversion provided to it. Enforcement has proven that the Respondents' conduct was negligent, perhaps even grossly negligent, but not reckless.

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[27] *See Tuchman v. DSC Communications Corp.*, 14 F.3d 1061, 1067 (5th Cir. 1994), 1994 U.S. App. LEXIS 3326, at *14 (5th Cir. Feb. 24, 1994).

2. The Respondents' omissions violated NASD Conduct Rule 2110

Although the Gebharts' omissions were not fraudulent, they did violate NASD Conduct Rule 2110. NASD Conduct Rule 2110 does not require scienter; negligent omissions violate that Rule.[28] Consequently, although the Respondents did not intend to mislead their customers, their reliance on Mr. Archer's representations about how MHP operated was unreasonable, and their omissions did mislead their customers, and constituted negligent behavior.

The Hearing Panel finds that the Gebharts' negligent failure to disclose material information to their customers, in connection with their recommendations to purchase the MHP promissory notes, violated NASD Conduct Rule 2110.

E. The Respondents Failed to Obtain Prior Written Approval from their Employer, Mutual Service, Before Selling Securities, in Violation of NASD Conduct Rules 3040 and 2110

NASD Conduct Rule 3040 requires that an associated person who intends to participate in a

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[28] *See Dept of Enforcement v. Reynolds*, No. CAF990018, 2001 NASD Discip. LEXIS 17, at *47 (NAC June 25, 2001) (finding a Rule 2110 violation, but not fraud, where representative's investigation was inadequate, his reliance on issuer's representations was unreasonable, and his assumptions mistaken).

private securities transaction "provide written notice to the member with which he is associated describing in detail the proposed transaction and the person's proposed role therein and stating whether he has received or may receive selling compensation in connection with the transaction. . . ." Further, if the transaction is for compensation, the member firm must approve or disapprove of the proposed transaction in writing.

Rule 3040 defines a "private securities transaction" as "any securities transaction outside the regular course or scope of an associated person's employment with a member, including, though not limited to, new offerings of securities which are not registered with the Commission." Proof of scienter is not required to establish a violation of Conduct Rule 3040. Consequently, although Respondents did not realize that the MHP promissory notes were securities, their ignorance is not a defense to a finding of liability.

Mutual Service did not sell the MHP promissory notes and they were not on the Firm's approved product list. (Tr. pp. 105-106). The MHP promissory note transactions also were not supervised by Mutual Service, or recorded on the Firm's books and records. As such, the sales of MHP promissory notes were sales outside the regular course and scope of the Gebharts' employment with the Firm.

The Respondents intended for the October 23, 1996 letter to put Mutual Service on notice of their intent to participate in the MHP promissory note

program, but it did not meet the requirements of NASD Conduct Rule 3040. The letter did not describe in detail the proposed transaction, the Respondents' roles in the transactions, or whether the Respondents would receive compensation for the transactions. Moreover, the Respondents never received the required written approval from the Firm.

Therefore, the Hearing Panel finds that Respondents violated NASD Conduct Rules 3040 and 2110.

III. Sanctions

"Although SEC case law and NASD practice strongly suggest that sanctions generally be assessed per cause, where multiple, related violations arise as a result of a single underlying problem, a single set of sanctions may be more appropriate to achieve NASD's remedial goals."[29] In this case, the Hearing Panel concludes that a single set of sanctions is appropriate because the sale of unregistered securities, the negligent omissions of material information, and the private securities transactions all arose from the Respondents' involvement in the sale of the MHP notes, and their failure to obtain approval from the Firm for that involvement.

The NASD Sanction Guidelines for sales of unregistered securities provide for fines ranging from

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[29] *Dept of Enforcement v. Investment Management, Inc.*, No. C3A010045 (NAC Dec. 15, 2003).

$2,500 to $50,000, and in egregious cases a suspension of up to two years or a bar.[30] The Guidelines for negligent misrepresentations or material omissions of fact recommend a fine ranging from $2,500 to $50,000, and suspension for up to 30 business days.[31] The Guidelines for Private Securities Transactions, effective December 2003, suggest fines ranging from $5,000 to $50,000, which the adjudicator may increase by the amount of respondent's financial benefit. The Guideline, as revised, also suggests suspensions, ranging from 10 business days for sales activities involving sales of up to $100,000, to a 12 month suspension, or a bar, for sales activities involving sales in excess of $1,000,000, which suspensions the adjudicator may increase or decrease after considering other applicable aggravating or mitigating factors.[32] Arguing that the Respondents' actions were especially egregious, Enforcement recommended that the Respondents be barred.

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[30] NASD Sanction Guidelines, p. 30 (2001).

[31] *Id.* at 96.

[32] Special NASD Notice to Members 03-65 (Oct. 2003). The Guidelines, as revised, recommend that adjudicators first assess the extent of the selling away, including the dollar amount of sales, the number of customers, and the length of time over which the selling away occurred. Following the assessment of the extent of the selling away, adjudicators are advised to consider the ten other factors listed in the Guideline, which includes six of the general considerations listed in the introductory section of the Guidelines.

The Hearing Panel considered the following factors in arriving at specific sanctions:

A. Extent of the Selling Away

1. Dollar Volume of Sales

The dollar volume of sales was in excess of $1,000,000.[33]

2. Number of Customers

The selling away activity involved 45 customers.

3. Length of Time

The Respondents were engaged in the offer and sale of the MHP promissory notes for more than three years, beginning in 1997 and continuing through February of 2000.

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[33] In assessing the extent of the selling away, the Hearing Panel noted that the Respondents waited approximately three months after providing the October 1996 disclosure about mobile home park conversions to Mutual Service before they began soliciting customers. The Hearing Panel also noted that more than one-half of the $2.4 million in sales originated by the Respondents occurred after the Respondents put the Firm on specific notice of the activity by listing 2nd deeds of trust on their 1999 Representative questionnaires.

B. Other Private Securities Considerations

4. Whether product sold away involved a violation of federal or state securities laws, or federal, state or SRO rules

The sales of MHP promissory notes involved the sale of unregistered securities, which the Hearing Panel considered an aggravating factor.

5. Whether the Respondents had a proprietary interest in the issuer of the promissory notes

The Respondents did not have the aggravating factor of having a proprietary or ownership interest in MHP or CSG.

6. Whether the Respondents created the impression that the Firm sanctioned their activity

The Respondents put correspondence relating to the MHP promissory notes on letterhead with "Gebhart & Associates" on the top and "Securities offered through Mutual Service Corporation" on the bottom. (Tr. pp. 430-431). The Respondents also told their customers of the MHP promissory notes mainly during their routine conversations with existing customers. (Tr. p. 483).

Generally, creating an impression for customers that the Firm sanctioned the sales of the product

would be considered a serious aggravating factor. However, in this case, because the Respondents sincerely believed that Mutual Service was aware of their participation in the MHP program, the creation of the impression of approval was deemed by the Hearing Panel to be a minor aggravating factor.[34]

7. Whether the Respondents' activity resulted in injury to the investing public

The Respondents' misconduct indirectly resulted in substantial injury to the investing public.[35] Although the Respondents' customers and the Respondents invested $2.4 million in the program over the three year period, only those customers who invested after March 1999 were subject to a loss, and due to the Respondents' efforts the customers are expected to recoup approximately 84% of their investments.

8. Whether the Respondents sold away to customers of the employer

Some of the customers to whom the MHP promissory notes were sold were customers of Mutual Service. The Respondents offered and sold the MHP

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[34] The Respondents believed that Mutual Service did not object to them selling MHP promissory notes. (Tr. p. 876).

[35] MHP's failure to record properly the deeds of trusts on the mobile home parks was the direct cause of the Respondents' customers' injuries.

promissory notes from their Mutual Service office, primarily to their existing customers in their capacity as their Mutual Service adviser.

9. Whether the Respondents provided their employer firm with verbal notice of the proposed transactions

The Respondents not only provided oral notice to the Firm of the mobile home park program, but they also provided written information about the program to the Firm's compliance department. The notice that the Respondents provided was not sufficient to meet the requirements of Conduct Rule 3040; however, the Hearing Panel finds that the notice provided was a substantial mitigating factor.

10. Whether the Respondents sold away after being instructed not to do so

The Respondents did not continue to sell the MHP promissory notes after being instructed not to do so. Although Mr. Archer was advised by MONY that the MHP promissory notes should not be sold in November 1999, he admitted that he did not relay that information to the Respondents.

11. Whether the Respondents participated in the sale by referring customers or selling the product directly to customers

The Respondents participated in the sale of the MHP promissory notes by selling the product directly to their customers. The Hearing Panel viewed this as more of an aggravating factor for Respondent AG than for Respondent DG. Although both Respondents testified that they were equally responsible for the sales to their customers, based on their testimony concerning who made the presentations to the customers, it is clear that Respondent AG was the primary promoter of the MHP promissory notes. It was Respondent AG who had the initial conversation with Mr. Archer, who instigated the telephone call with Mr. Poston to discuss the product, and who was Respondent DG's mentor.

12. Whether the Respondents recruited other registered individuals to sell the product

Respondent AG was responsible, in part, for Respondent DG becoming involved in selling the MHP promissory notes. Nevertheless, the Hearing Panel finds that this factor will not be deemed as aggravating because the customers were viewed as joint customers.

13. Whether the Respondents misled their employer or otherwise concealed the selling away activity

Contrary to Enforcement's argument, the Hearing Panel finds that the Respondents did not deliberately attempt to conceal the MHP promissory note transactions from their employer. The Respondents did not intentionally conceal their participation in the MHP program from the Firm's compliance auditor. (Tr. pp. 760-761, 924). The Respondents' failure to disclose the MHP program on the pre-1999 surveys and questionnaires involved a series of misunderstandings, rather than a deliberate attempt to mislead.

The Respondents interpreted the questions on the compliance surveys as soliciting information about new programs. The Respondents did not perceive the MHP program as a new program because they were under the impression that Mutual Service was aware of their activities based on the October 1996 telephone conversation and mailing. Partly because of their interactions with the Firm concerning their insurance activities, and partly because of their unfamiliarity with securities products concepts, with each subsequent contact with Mutual Service, including their interaction with the operations department of Mutual Service and the auditor's review of their business logs, reinforced the Respondents' misimpression that Mutual Service had specifically considered the MHP program and determined that there were no compliance issues.

C. Other Factors

14. The Respondents undertook voluntary efforts to assist their customers to recover their investments

The Respondents immediately took action when they realized there was a problem with the MHP program. Their efforts in initiating the involuntary bankruptcy of CSG and in pursuing their insurer for additional funds are expected to result in reimbursement of at least 84% of the MHP note holders' principal.

Although not listed as a consideration in the Sanction Guidelines for private securities transactions, consistent with the NAC's reasoning in Dept of Enforcement v. Fergus, No. C10990025 (NAC May 17, 2001), the Hearing Panel finds that the Respondents' voluntary and proactive efforts to assist their customers in recovering their funds, which were undertaken prior to discovery by the Firm or NASD, should be encouraged and constitutes a mitigating factor.

The Hearing Panel was favorably impressed with the Respondents' remorse and sincerity. The Hearing Panel finds that the Respondents did not recommend the MHP promissory notes primarily because of the commissions that they expected to earn on the product. The Respondents were attempting to meet their clients desire for a fixed rate, short-term financial instrument. In fact, the Respondents had personally invested in the program almost a year

before they made an initial presentation to a customer. The Hearing Panel is convinced that the Respondents will not engage in similar misconduct in the future and will not be a danger to the investing public.

15. Unregistered Securities/Negligent Omissions

In addition to reviewing the factors applicable to private securities transactions, the Hearing Panel considered whether there were any additional factors listed in the Sanction Guidelines for unregistered securities and negligent omissions that needed to be considered. There were no additional factors. The applicable principal consideration in determining the sanctions for the sale of unregistered securities is the share volume and dollar amount of the transactions. The applicable factors for determining the sanctions for negligent omissions are the factors listed in the introductory section, including whether the respondent voluntarily and reasonably attempted to remedy the misconduct, whether the respondent engaged in numerous acts, whether the respondent engaged in the misconduct over an extended period of time, whether the respondent attempted to conceal his or her misconduct, etc. Accordingly, the Hearing Panel has already considered the factors listed in the Sanction Guidelines for unregistered securities and negligent omissions.

D. Sanctions to be Imposed

After applying each of the factors listed above to the two Respondents, and determining that as between Respondent AG and Respondent DG, Respondent AG was primarily responsible for the activity, the Hearing Panel determined that the following sanctions should be imposed:

1. Respondent AG

For violating NASD Conduct Rules 3040 and 2110, by offering and selling unregistered securities by means of material omissions, without providing prior written notice to, and approval of, his employer, Respondent Alvin W. Gebhart, Jr. is suspended for 12 months in all capacities and fined $100,000.

2. Respondent DG

For violating NASD Conduct Rules 3040 and 2110, by assisting Respondent AG in offering and selling unregistered securities by means of material omissions, without providing prior written notice to, and approval of, her employer, Respondent Donna T. Gebhart is suspended for seven months in her capacity as a general securities representative and fined $7,500.

3. The Respondents

The Hearing Panel also orders the Respondents to pay jointly and severally the $5,141.21 costs of the Hearing.

IV. Conclusion

For violating NASD Conduct Rules 3040 and 2110, by offering and selling unregistered securities by means of material omissions, without providing prior written notice to, and approval of, his employer, Respondent Alvin W. Gebhart, Jr. is suspended for 12 months in all capacities and fined $100,000.

For violating NASD Conduct Rules 3040 and 2110, by offering and selling unregistered securities by means of material omissions, without providing prior written notice to, and approval of, her employer, Respondent Donna T. Gebhart is suspended for seven months in her capacity as a general securities representative and fined $7,500.

The Hearing Panel also orders the Respondents jointly and severally to pay the $5,141.21 costs of the Hearing, which include an administrative fee of $750 and Hearing transcript costs of $4,391.21.

If this Decision becomes the final disciplinary action of NASD, the suspension of Respondent Alvin W. Gebhart, Jr. in all capacities shall commence with the opening of business on Monday, April 5, 2004, and end at the close of business on April 4, 2005; Respondent Donna T. Gebhart's suspension in her capacity as a general securities representative shall commence

with the opening of business on Monday, April 5, 2004, and end at the close of business on November 4, 2004.

The Respondents' fines and costs shall become due and payable upon their re-entry into the securities industry.[36]

HEARING PANEL

By: Sharon Witherspoon
Hearing Officer

Dated: Washington, DC
February 9, 2004

Copies to:
John T. Archer (via Federal Express and first class mail)
Alvin W. Gebhart, Jr. (via Federal Express and first class mail)
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[36] The Hearing Panel has considered all of the arguments of the Parties. They are rejected or sustained to the extent that they are inconsistent or in accord with the views expressed herein.